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Instead of FIRA
Autonomy For Canadian Subsidiaries?

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SAMUEL WEX

The Institute for Research on Public Policy/

L'Institut de recherches politiques

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The Institute for Research on Public Policy/
L'Institut de recherches politiques
2149 Mackay Street
Montreal, Quebec
H3G 2J2

To
Anna

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Foreword

No sooner were Canadians confident of the prosperity of the country, following the post-war re-establishment of our economy, than many began to worry about foreign ownership of Canadian businesses. Resource development, especially, had depended on a major inflow of equity capital, largely from the United States. In the manufacturing sector, Canadian subsidiaries of American and other foreign corporations had long been established. They grew, and new ones were introduced. Canada relied heavily on foreign sources of both capital and technology, and many Canadians became increasingly worried about the degree of foreign ownership and the control of Canadian interests that went with it.

As Mr. Wex points out, four reports were submitted to the federal government, between 1957 and 1972, on a whole range of adverse consequences believed to arise from foreign investment, of which the most salient were low productivity of manufacturing firms in Canada and the threat of foreign domination of the Canadian economy. The Foreign Investment Review Act was the main response to the problem. However, although this Act has helped to ensure that foreign investment produces significant benefits for Canada, it was not designed to deal directly with the productivity problem.

It is generally recognized that productivity is of growing importance as tariff levels are reduced, and as the international organization of production becomes increasingly specialized. In this changing environment, the pressures are increasing for Canadian subsidiaries of foreign firms to switch from replicating their parents' lines of products to making specialized products for international markets.

Mr. Wex argues that increased autonomy of Canadian subsidiaries will enable them to develop an entrepreneurial spirit and an innovative capability. These characteristics are essential for achieving increased productivity and developing international markets. He claims, moreover, that the best way to ensure this achievement is not through a screening agency such as the Foreign Investment Review Agency (FIRA), which does not address the autonomy issue directly, but through the recognition and protection of an appropriate measure of autonomy for subsidiaries of foreign firms, whether through the legal system or through independent directors who would protect this autonomy. In the course of his analysis, he points out that such legal recognition and protection has progressed further in other countries than it has in Canada.

At a time when Canadians are particularly worried about our high level of unemployment and Canada's performance in an increasingly competitive world economic climate, Mr. Wex's proposals make a valuable contribution to discussion of these very real problems.

Gordon Robertson
Past President and Fellow-in-Residence

July 1984

Avant-propos

Une fois l'économie rétablie après la guerre, les Canadiens n'avaient pas si tôt repris confiance en la prospérité de leur pays que nombre d'entre eux commencèrent à s'inquiéter du contrôle des entreprises canadiennes par des étrangers. La mise en valeur des ressources en particulier avait reposé sur l'apport de capital-actions étranger, surtout des États-Unis. Dans le secteur manufacturier, la présence de filiales canadiennes de sociétés américaines ou autres était bien implantée. Ces entreprises avaient prospéré et d'autres avaient vu le jour. Le Canada comptait énormément sur des sources de capital et de technologie étrangères et de nombreux Canadiens s'inquiétèrent de plus en plus de l'ampleur de cette mainmise étrangère et de l'emprise sur nos intérêts qui en découlait.

Comme le souligne M. Wex, le gouvernement fédéral recevait, de 1957 à 1972, quatre rapports faisant état d'une série de conséquences néfastes, présumées découler de l'investissement étranger, et dont les plus frappantes étaient la faible productivité des entreprises manufacturières canadiennes, et la menace d'une domination étrangère de l'économie canadienne. La Loi sur l'examen de l'investissement étranger fut la principale solution au problème. Bien que cette loi permit de s'assurer que l'investissement étranger produisse des avantages marquants pour le Canada, elle ne fut pas conçue pour régler directement le problème de la productivité.

L'on admet couramment que l'importance de la productivité croît avec la diminution des niveaux tarifaires et avec la spécialisation accrue de l'organisation internationale de la production dans les pays industrialisés. Dans ce monde changeant, les pressions sur les filiales canadiennes de sociétés étrangères se font de plus en plus

pressantes pour qu'elles passent de la copie de produits de la société mère à la fabrication de produits spécialisés pour les marchés internationaux.

M. Wex soutient que l'autonomie accrue des filiales canadiennes leur permettra de développer un esprit d'entreprise et une capacité d'innovation. Ces deux caractéristiques sont vitales pour la croissance de la productivité et l'expansion des marchés internationaux. De plus, selon l'auteur, la meilleure façon de réaliser cet objectif n'est pas par le truchement d'une agence d'examen telle que l'Agence d'examen de l'investissement étranger (AEIE) qui ne répond pas directement à la question d'autonomie, mais plutôt par la reconnaissance et la protection d'une règlementation adéquate de l'autonomie pour les filiales de sociétés étrangères. Ceci serait faisable, soit par un régime de droit, soit par des membres indépendants de conseils d'administration, qui protégeraient cette autonomie. Au cours de son analyse, M. Wex fait remarquer que de telles mesures de reconnaissance et de protection légales sont plus avancées dans d'autres pays qu'au Canada.

À un moment où les Canadiens se préoccupent particulièrement de notre niveau élevé de chômage, ainsi que du rendement de l'économie canadienne dans un climat économique mondial de plus en plus concurrentiel, les propositions de M. Wex apportent une contribution valable à la discussion de ces problèmes très concrets.

Gordon Robertson
Ancien président

Juillet 1984

The Author

Samuel Wex is an international lawyer, an official in the public service of Canada, Adjunct Professor of international law and international affairs, and author of numerous articles. He has taught courses on international economic law issues at McGill and the University of Ottawa, and a course on international negotiation at Carleton University's School of International Affairs. He has served as legal advisor to a bilateral (Canada-United States) organization, which dealt with transboundary resource-sharing issues. Mr. Wex has received a research award from the International Development Research Centre to study the transfer of technology from the multinational enterprise.

Acknowledgements

The idea for this paper took shape three years ago at a seminar, held at McGill's Comparative Law Institute, on international and domestic approaches to regulating the multinational enterprise (MNE). Comparative law approaches to regulating the MNE were examined; that is, the participants considered how international organizations and other countries have dealt with the parent-subsidiary relationship, as well as the implications for Canada. I am grateful to my former students at McGill and the University of Ottawa for the clarification which followed on our discussions. In addition, there are friends and colleagues, too numerous to mention, who helped me with their advice and encouragement. I deeply appreciate their contribution to my work. I am particularly indebted to those who commented on previous drafts, especially Harvey Lazar. I am grateful for the editorial assistance of John Hayes and Jo File.

Lastly, if it were not for the encouragement and patience of Gordon Robertson and the support of the Institute for Research on Public Policy, this opportunity to generate discussion on encouraging international competitiveness of foreign subsidiaries in Canada would have been missed. I am particularly appreciative of their support. The opinions expressed and responsibility for them remain, however, my own.

Samuel Wex

Ottawa
July 1984

Summary

This study suggests a new way of dealing with the question of relationships between foreign parents and their Canadian subsidiaries. If its suggestions were adopted, Canadian subsidiaries would be better able to restore Canada's competitiveness in the international market for manufactured goods.

That competitiveness has been slipping. One reason for this is that subsidiaries, which account for a substantial share of Canadian manufacturing output, often lack the entrepreneurial spirit that breeds innovation and success in foreign and domestic markets. It is the author's belief that an entrepreneurial spirit can flourish only if a subsidiary has sufficient autonomy: that is, if it has a large measure of freedom to make decisions about research and development, product lines, and so on. Absolute freedom for foreign-controlled subsidiaries within an internationally organized enterprise is unlikely, but much can be done to enlarge the decision-making authority of these firms. Some Canadian subsidiaries are now being given a world product mandate: that is, the opportunity to sell its product world wide.

Can one rely on foreign parents to provide their subsidiaries with the requisite measure of autonomy to develop their own potential? Experience both in Canada and elsewhere indicates that some degree of government intervention is needed to achieve this end. However, the Foreign Investment Review Agency (FIRA) does not address the autonomy issue directly because its supporting legislation implicitly recognizes continued foreign control over a subsidiary's decisions.

Legislation to give a subsidiary a greater degree of autonomy — to protect it against disadvantageous instructions from a parent — is already in place in certain countries that are members of the Organisation for Economic Co-operation and Development (OECD). This paper advocates for Canada a stronger role for independent directors on the boards of subsidiary companies, supplemented as necessary by provisions in company, anti-combines and similar laws.

Given the changing pattern of international production of manufactured goods, it is essential that foreign-controlled firms be encouraged to seek out foreign markets, and that they be afforded the opportunity to develop new product lines and new marketing skills. Greater autonomy will facilitate those developments, and new legislative rules may be needed to help increase their degree of autonomy.

Abrégé

Cette étude propose une nouvelle approche de la question des rapports entre les sociétés mères étrangères et leurs filiales canadiennes. Si l'on acceptait ses conclusions, les filiales canadiennes seraient en meilleure mesure pour restaurer la position concurrentielle du Canada sur le marché international de produits manufacturés.

Cette position concurrentielle a perdu de son élan. Ceci est en partie dû au fait que les filiales, qui représentent une section importante de la capacité manufacturière canadienne, ne possèdent pas souvent l'esprit d'entreprise, créateur d'innovation et de succès sur le marché national et international. L'auteur est convaincu qu'un esprit d'entreprise ne peut se développer que dans les cas où une filiale jouit d'une autonomie suffisante : c'est-à-dire, si elle dispose d'une grande marge de liberté pour prendre des décisions concernant la recherche et le développement, les gammes de produits et ainsi de suite. La liberté absolue, pour des filiales contrôlées de l'étranger et qui font partie d'une entreprise organisée à l'échelle internationale, est peu probable, mais on peut cependant faire beaucoup pour accroître le pouvoir de décision de ces firmes. Certaines filiales canadiennes sont maintenant munies d'un mandat international pour leurs produits : c'est-à-dire, la possibilité de vendre un produit standardisé à l'échelle internationale.

Peut-on croire que les sociétés mères fourniront à leurs filiales la mesure d'autonomie requise au développement de leur propre potentiel? Les expériences, tant au Canada qu'ailleurs, ont démontré qu'il faut une certaine mesure d'intervention gouvernementale pour réaliser ce but. Cependant, l'Agence d'examen de

l'investissement étranger (AEIE) ne répond pas directement à la question d'autonomie en tant que telle, car sa législation de base reconnaît implicitement que l'étranger exerce un contrôle continu des décisions d'une filiale.

La législation permettant une plus grande marge d'autonomie à une filiale, afin de la protéger des instructions inappropriées d'une société mère, existe déjà dans certains pays membres de l'Organisation pour la coopération et le développement économique (OCDE). Cette étude propose pour le Canada que les membres indépendants des conseils d'administration des filiales aient un rôle plus important, complémenté au besoin par des dispositions législatives touchant les sociétés, les cartels et domaines semblables.

Etant donné les changements dans la production internationale des produits manufacturés, il faut que les sociétés sous domination étrangère soient encouragées à rechercher des marchés étrangers et qu'on leur donne l'occasion de lancer de nouvelles gammes de produits et développer de nouvelles aptitudes à la gestion. Une autonomie accrue faciliterait ces démarches, et de nouveaux règlements législatifs aideront à accroître leur degré d'autonomie.

1: *An Overview*

The Setting

Instead of Europeans facing *le défi américain*, it now seems that it is the Americans — and Canadians — who are facing the economic challenge of the 1980s and beyond. The problems facing the U.S. manufacturing sector have become popularized in best-selling texts. These problems include standardized production in an increasingly specialized international market-place; an excessively short-term focus on profits; take-overs that do not contribute to increasing a nation's wealth; and an inability to move quickly out of those sectors in which U.S. industry is no longer competitive, into those where it is becoming competitive and is likely to remain so. It is argued that business must change from standardized to specialized and flexible systems of production, incorporating innovative capacity, entrepreneurial skills, and autonomy in decision making, so as to be able to respond continually to change in international markets. International Business Machines (IBM), often cited as an example of one of America's best-run companies, has pursued decentralization (or autonomy of its units) to foster environments where creative people can flourish. An innovative company fosters many entrepreneurs and innovators throughout its organization. Entrepreneurship and autonomy go hand in hand. For the United States, the diagnosis and the prescription are attracting favourable attention. But for a country in which a large segment of the manufacturing sector is foreign controlled, the problem is more complex. Canada's problem is how to encourage innovative, entrepreneurial, specialized and autonomous, foreign-controlled subsidiaries.

Recent international reports confirm that Canada's competitive position has deteriorated over the past few years. The causes are our lack of industrial efficiency or productivity and our poor record of innovation and of research and development (R & D). Foreign-controlled businesses are not geared up generally to sell into the international market-place as independent entrepreneurs and, hence, are less efficient by international standards. Increased productivity requires innovation, entrepreneurship and autonomy in decision making. While Canadian public policy must seek to support and encourage increased productivity for all business activity, this paper is concerned with the almost 50 per cent of manufacturing output that is foreign controlled. For many foreign-controlled firms, decision making continues to reside with the foreign parent company, and this has usually meant that innovation and international competitiveness have been lacking.

This paper examines approaches to promoting the Canadian subsidiary's autonomy. It is suggested that the problems facing us today are different from those of the 1960s and early 1970s, which gave rise to the Foreign Investment Review Agency (FIRA): branch plants that existed then are expected to disappear as tariffs fall; the international organization of production is changing from standardized to specialized products. In this environment, the branch plant may be closed down or be replaced by a 'rationalized production' subsidiary supplying components for the parent, but with no innovative R & D of its own. Neither of these results meets Canada's need for increased industrial efficiency, utilizing innovative capacity. There is, however, a third possible result, particularly when improved communication systems allowing for the two-way flow of technology are taken into account, and that is the development of subsidiaries that are innovative. The difference between a rationalized production subsidiary and an innovative subsidiary is, in large part, attributable to the source of the key decisions relating to the subsidiary's activities: Is the parent or the subsidiary the decision maker? The public policy approach proposed in this paper seeks to promote that third possibility. Instead of conceding continued foreign control over decision making, and negotiating detailed undertakings by the foreign investor relating to employment, capital, R & D and other matters — as FIRA now does — Canadians should really be focusing on ways to encourage greater autonomy for the Canadian subsidiary, and on means whereby that subsidiary may acquire an opportunity to develop an innovative capacity. It is timely, then, to re-examine the current approach that relies heavily on FIRA.

The Purpose

The pattern of growth and development of the multi-national enterprise (MNE) in the manufacturing sector can be expected to change over the course of this decade, with important implications for its foreign subsidiaries. For Canada, where a significant proportion of the output in the manufacturing sector is foreign owned and controlled, largely by MNEs, those implications are matters for urgent public policy debate.

The expected changes may be attributed primarily to the emerging shift, particularly in the developed countries, in the organization of international production away from standardized production towards increased product specialization using advanced technology. Canada, with its high wage rates and highly skilled work force, will be directly affected. Because of an increasingly competitive international market-place, and because specialized products will generally not find a sufficient market in Canada to sustain commercial activity, international acceptance of product or process will be needed to achieve success. Finding a niche in international markets requires the creation of a distinctive advantage, whether in product, marketing or price. Attaining this advantage in the international market-place requires the development of an innovative product or process which, in turn, requires:

- An opportunity or the freedom to develop an innovative capacity
- An entrepreneurial spirit.

If Canadian subsidiaries could acquire these characteristics, their increased productivity would help to arrest Canada's alarming rate of decline in exports of manufactured goods. Improving our productivity is our best assurance of achieving the objectives we all think worthwhile: economic growth and employment; different outlets for people's differing skills and interests; higher living standards. The situation is all the more urgent because the latest round of tariff reductions is being phased in to take effect by 1987. Although some products will continue to enjoy relatively high levels of tariff protection, the reductions are expected to remove much of the protective barrier that has insulated Canadian firms, including foreign-controlled subsidiaries, from foreign competition.

The problem of foreign control was identified over ten years ago in the Gray Report and is recognized in the purpose clause of the Foreign Investment Review (FIR) Act. The problem frequently arose because the parent controlled all decisions relating to the territory and jurisdiction of the subsidiary and the products that it

could sell into that territory. In the end, the subsidiary's marketing activities were usually limited to the domestic market, and the location and extent of its research and development (R&D) activities were effectively determined by the parent firm, which usually allocated meagre R&D resources to the subsidiary.

The FIR Act sought to counterbalance, rather than solve, this control problem by exacting performance undertakings to ensure that the foreign investment would be of 'significant benefit to Canada'. Its scope extended both to new foreign investments and to expansions of existing foreign-controlled firms into unrelated businesses. The MNEs are asked to undertake these commitments as a condition of their setting up business in Canada. This approach is intended to improve employment, technology transfer (R&D), and other performance-related objectives. Apart from its associated costs,[1] it neither addresses *directly* the problem identified in the Gray Report and the statute, that is, the lack of control, nor does it *necessarily* focus on establishing a productive subsidiary with an innovative capacity. While such an objective may be attained indirectly through performance undertakings, these undertakings are sought for the direct benefits they produce, and not necessarily for the indirect benefit of increased productivity.

The alternative approach suggested in this paper is to encourage the decentralization of decision making by transferring a degree of authority to the Canadian subsidiary and so fostering the development of an autonomous subsidiary with interests independent of its parent firm. In 1975 the Gillespie Guidelines of Principles of International Business Conduct also stated this objective. Is it an objective consistent with the MNE's organization of production?

The MNE: Change-over from Market-Seeker Model to Production-Efficiency-Seeker Model

MNEs generally located their manufacturing subsidiaries in Canada in order to capture a share of our domestic market. A subsidiary that has this purpose may be termed a 'market seeker' to distinguish it from a 'production-efficiency seeker', which an MNE uses to produce a product most efficiently for world markets. The market seeker's aim was to replicate the parent's entire product line — or as much of it as possible — for the Canadian market. No innovative capacity or entrepreneurial spirit was required of the market seeker, save that necessary to build a market share based on the parent's

technology, 'know-how' and marketing, such as spill-over advertising. Given a smaller population, higher wage rates, and higher transportation costs than our major competitors, the branch plant was not efficient by international standards. However, it thrived behind the protection of high tariffs. Its success was the greater because it was usually larger than its domestic competitors, and this advantage enabled many foreign-controlled subsidiaries to capture a large share of the Canadian market.

Even though foreign-controlled subsidiaries may be more productive than their Canadian counterparts in the manufacturing sector,[2] the productivity of this sector, in general, has declined during the past decade. This reduction manifests itself in our declining relative share of export markets and a large trade deficit in manufactured goods.[3] It is essential, then, that Canadian public policy encourage the international competitiveness of all business in Canada, including the almost 50 per cent of manufacturing output that is largely attributable to these subsidiaries.

International competitiveness is linked to increased specialization, with all the risks that this development may entail.[4] For increased specialization of production to occur in a country of Canada's size requires, in general, that the subsidiaries be able to compete in the international market-place. In order to do so, the subsidiaries must be able to capitalize quickly on opportunities in this larger market-place, or they must be "especially adroit at continually responding to change of any sort in their environments."[5] Only innovative companies can fill this bill, and in the Canadian context, it is only those businesses which have the freedom to search out opportunities and to capitalize on them quickly that can achieve success in a specialized international market-place. In that environment, the traditional market seeker is not expected to survive.[6] Over time, MNEs will close down their subsidiaries in Canada, or a large share of their production will be rationalized — that is, a few components will be produced for a larger geographic area (as under the Auto Pact) — or a large share of their production will be devoted to producing finished, specialized goods for world-wide or North American markets. The successful subsidiary will be one that seeks, instead of domestic markets, efficient production by international standards.

New Subsidiary Model: Production Efficiency with an Innovative Capacity

The type of production-efficiency model that we should strive for is one in which all business activities are brought together within the subsidiary for as many products or business units as possible: design engineering, R&D, purchasing, manufacturing, distribution, marketing and sales. This arrangement is totally different from the traditional market-seeker model, in which there was no opportunity to innovate. In the latter model:

- R&D, if any, was limited to simple adaptation to the Canadian market-place (that is, to adjustments for measurement, climatic conditions, and other similar differences from the parent's country).
- Manufacturing was largely an assembly operation.
- Marketing amounted to an extension of the parent's distribution network.

The subsidiary model suggested in this paper is to have autonomy in making the key R&D, manufacturing and marketing decisions that would permit it to pursue international business opportunities consistent with an efficient international organization of production in its sector.

Increasingly, mass production of labour-intensive standardized products will move to subsidiaries in developing countries. But that development should not preclude — as it has over the last few years — the manufacture, in Canada, of high-tech standardized products for international markets. Moreover, production of relatively limited quantities of specialized products for international markets can also be located in developed countries like Canada. The type of production to be encouraged is finished goods for international markets, rather than rationalized production of components for captive markets, such as building parts for a parent firm. Relatively high wage rates and skills in Canada, and the higher economic growth which high-technology products can generate, all support a highly efficient subsidiary with an innovative capacity. It has been shown that competitive advantage is tied to innovative technology and marketing skills which are developed 'in house'. The other side of the coin is that innovative firms are especially adroit at responding to change. To develop this in-house capability requires that authority and responsibility be delegated to the foreign-controlled subsidiary, and this development, in turn, fosters an attitude of autonomy and of the 'will to survive', which may motivate the subsidiary's management to acquire as large a degree as possible of control or autonomy in decision making.

Autonomy would not only improve efficiency, but would also help to end what may be characterized as abuses of decision-making control by the parent company. Recent newspaper articles on activities of subsidiaries exemplify abuses that may require attention:

- A parent company buys an innovative business and sets it up as a wholly-owned subsidiary to stifle its product development and thereby protect the parent's business.
- A parent company in a single-product industry, such as automobile manufacture, with rationalized production in a large geographic area, such as North America, purchases all its supply of a major input in the United States, although Canadian producers offer better prices. This action prevents its subsidiaries from buying competitive Canadian supplies.
- A parent company takes over the international operations built up by its subsidiary.
- A parent company repatriates huge dividends, thereby severely affecting the financial resources underpinning its subsidiary's activities.
- A parent company threatens to close down its subsidiary if sued by the host-state government for defective manufacture.

The Proposal

It is becoming increasingly apparent that certain decision-making powers can be transferred from a foreign parent to its Canadian subsidiary for certain business units or products, consistent with an MNE global perspective.[7] If subsidiaries were to behave more independently of the parent — that is, if they could decide with greater independence to innovate and to export, and so forth — then there would be less need for screening foreign investment. It follows that an autonomous subsidiary would, at the same time, have the opportunity to compete internationally.

It has hitherto been seen as the parent firm's exclusive preserve to exercise control over the activities assigned to a subsidiary. But one may question the principle that a parent firm is entitled, in all instances, to direct the policies of its subsidiaries. This study asks whether the law should support an autonomous subsidiary in exercising an appropriate degree of decision-making power. It also asks how Canada might implement laws of general application that seek to put limits on the parent's rights, or how the subsidiary might regulate itself through independent directors.

Law may be seen as an instrument by which man in society consciously tries to change his environment, or by which he tries to facilitate or accelerate the changing of his environment. The framework response proposed here focuses on the latter concept: the international economic environment is changing, and in the public interest, the law should accommodate, and even accelerate, this change. The legal principle supporting the changing organization of production would be the recognition in law of the subsidiary's autonomous interest. Given this recognition, a parent company would not be able to abuse its decision-making authority with respect to its subsidiary. That a subsidiary may have an autonomous interest is increasingly recognized in international dialogue and in certain European jurisdictions and courts.

This principle must be seen to be workable and consistent with the notion of achieving international competitiveness through increased productivity. Moreover, all legislation implementing the proposal would be consistent with Canada's international obligations. Implementation of an autonomous subsidiary-interest principle would require two stages. For the first, or transitional stage, a modified Foreign Investment Review Agency (FIRA) is recommended which would redefine 'significant benefits to Canada' as recognition of a subsidiary's autonomous interest. Ultimately, 'significant benefits' would mean increased productivity and international competitiveness. Thus autonomy, and not performance requirements, would become the new FIRA test.

In this first stage, such recognition could take the form of a so-called 'sterilization' pact patterned on the one which the Ontario Securities Commission recently obtained when Prudential of America took over the Bache Group. The take-over had jeopardized the continued membership of Bache Halsey Stuart Canada Ltd. in the Toronto Stock Exchange. The purpose of the arrangement agreed upon was to strengthen the autonomy of the Canadian subsidiary: to insulate it, in this case, from the ultimate control of the parent company.

In the long term, fostering increased autonomy of a subsidiary can be accomplished without intervention: no FIRA or other screening agency would be required. Foreigners would be free to invest in Canada, provided they recognized the principle of an independent subsidiary interest.[8] In place of a discretionary regime, there could be laws of general application by which certain directions to a subsidiary would be prohibited as either anti-competitive or disadvantageous, and by which greater disclosure by the parent company of intra-enterprise activities would be promoted. Provided

the foreign investor adhered to the laws that promote a reasonable level of subsidiary autonomy, no further government intervention would be required. It is expected that the subsidiary would then be able to build on this autonomous interest an innovative capacity and an entrepreneurial spirit from which increased productivity and international competitiveness would follow.

Clarification of the role of directors in protecting the autonomous interest of foreign-owned subsidiaries is also needed. Is it the duty of directors to monitor and supervise intra-enterprise activities with a view to protecting this independent interest? Should outside directors be required for all subsidiaries or for those, at least, over a certain size? Is it necessary to strengthen their role in protecting the subsidiary's autonomous interest in intra-enterprise situations that could involve conflict of interest? Specific laws would be needed to bring this about.

The proposed approach recognizes that Canada is a trading nation and that international competitive pressures are growing; that growth in investment and productivity must be encouraged; and that the strengths of the private sector should be both recognized and promoted. The promotion of strengths inherent in the private sector could be accomplished through less government intervention — which would occur if there were no FIRA performance requirements — and through seeking a production-efficiency model tied to an innovative capacity, which happens to coincide with an emerging trend in the organization of international production. At the same time, the proposal seeks to address the particular problem of foreign control over decision making by encouraging increased devolution of authority, where appropriate, to Canadian-based management and to the subsidiary's board of directors.

Notes

1. Costs, it has been argued, are tied to government intervention. Host-state intervention in MNE activity has been categorized as constituting either 'limitations to strategic freedom' or a 'threat to managerial autonomy'. Intervention of the first kind sets the fiscal and regulatory 'rules of the game' for an MNE's decision to compete in a host state; it may do this, for example, by establishing conditions of sales and export volume, or by setting employment or investment targets as a condition of establishing production facilities. These restrictions limit the strategic freedom of the MNE, but do not really threaten its managerial autonomy, as occurs in the second kind of intervention, where the host state seeks to influence the MNE's decision-making process.

Workers' co-determination schemes in Europe may force MNE subsidiaries "to share their strategic decision-making with representatives of local constituencies — be they government officials, local business people, local workers, or local unions." The objective is to decentralize decision making by conferring decision-making powers on autonomous subsidiaries, and to arrange for those subsidiaries to share that process with one or another local constituency. See L.Y. Doz and C. K. Prahalad, "How MNCs cope with host government intervention", pp. 150–51. The approach put forward in this paper is distinctive in that it does not envisage a forced sharing of power with any local constituency. Instead, it encourages the devolution of decision making to autonomous subsidiaries.

2. Foreign-controlled subsidiaries have been found to be 19% more productive, primarily because of access to the parent's technology and, to a lesser extent, to its marketing. See Canada, *Report of the Royal Commission on Corporation Concentration*, pp. 194–206. On the other hand, Canadian-controlled firms, because of their more limited product range, are generally more specialized than foreign-controlled subsidiaries. See R. E. Caves, *Diversification, Foreign Investment and Scale in North American Manufacturing Industries*, p. 4.

3. Canada's productivity growth of 0.09% between 1974 and 1980 compares poorly with its industrial competitors: Japan, 4.04%; European Economic Community (EEC), 2.45%; United States, 0.86%. Canada's share of world exports of manufactured goods has fallen from 5.9% in 1967 to 4.6% in 1977 to 3.4% by 1979. Our trade deficit in manufactured goods rose from $3 billion in 1970 to a high point of $21 billion by 1980, then declined to $8 billion by mid-1983. This recent favourable shift is attributable, in part, to falling prices of resource-based products, relatively lower wage rates, and currency swings which have been working against the United States. Malmgren, however, paints a bleak picture of our long-term export potential: see H. Malmgren, "How Best to Live With the United States", p. 44. Not only have we missed the fast track of increasing trade with developing countries, but we have tied our economy to a declining U.S. economy; see Z. Zeman, "The World Economy in Which We Must Expect to Live", pp. 49–50. See J.D. Daly, "Weak Links in 'The Weakest Link'", p. 310 and Table 1, for an explanation of the increasing trade deficit to 1980; *contra* J.H.N. Britton and J.M. Gilmour, *The Weakest Link: A Technological Perspective on Canadian Industrial Underdevelopment*.

4. Increased specialization of Canadian production depends on international markets. It may mean that fewer companies will compete domestically, and that there will be more reliance on open international trading practices to ensure freer competition. It could also mean a more cyclical economy tied to the vagaries of the international business cycle. See Ontario, *The Report of the Advisory Committee on Global*

Product Mandating, p. 14. This recognition of increased risk is somewhat lessened by the fact that increased specialization is not an all-or-nothing strategy. It is not as if the subsidiary — at the outset, in any event — makes only one or two products for world markets. It is expected that the subsidiary would also continue to make other products for the domestic market-place, where it has the advantage of location economics or some other relative advantage in that market-place.

5. T.J. Peters and R.H. Waterman Jr., *In Search of Excellence: Lessons from America's Best-Run Companies*, p. 12.

6. R.L. Perry, "Tomorrow's Branch Plants: Industrial gaps left as U.S. withdraws", p. 21.

7. The discussion in this paper is confined to the Canadian manufacturing sector; the resource sector is excluded since it is a distinct policy area. Nor do we examine an incentives approach to increasing the international competitiveness of Canadian business in general. The entire manufacturing sector may not be susceptible to the same extent to the approach, discussed in this paper, of encouraging increased autonomy for foreign subsidiaries. A study of four such autonomous subsidiaries concluded that this approach is best suited to technology-intensive sectors, such as aerospace products, electronics and industrial electrical equipment. Further study is required to determine which sectors are more susceptible to improving productivity and international competitiveness by implementing an autonomous subsidiary interest. See Science Council of Canada, Working Group of Industrial Policies, *Multinationals and Industrial Strategy: The Role of World Product Mandates*, p. 71.

8. The equity investment by foreigners is not assumed to be limited to any threshold amount, such as 50% or 75%. In the Australian mineral sector, however, 'naturalized' companies may participate in certain new projects and ventures on the basis of a number of provisos: there must be a minimum of 25% Australian equity and a commitment to increase this amount to 51% within an unspecified time period; a majority of directors must be Australian citizens; and understandings must have been reached among the company, major shareholding interests, and the government about the exercise of voting powers relating to the company's business in Australia. The government is concerned that the "operations and policy of a naturalized or naturalizing company . . . be determined by its Australian board and that the proposed control operations . . . ensure the autonomy of the company . . ." (Summarized from material in David L. Anderson, *Foreign Investment Control in the Canadian Mineral Sector: Lessons from the Australian Experience*, pp. 79–81.) There is increasing evidence to support the Australian view that the behaviour of foreign-controlled subsidiaries with minority host-state shareholders differs from that of wholly-owned subsidiaries. The former demonstrate a heightened sense of

fiduciary responsibility to minority shareholders and, by extension, to the host state. In this paper we do not, however, advocate devolution of a minimum level of equity to Canadians. Rather, the underlying assumption is that we are dealing with wholly-owned subsidiaries.

2: *Foreign-Controlled Subsidiaries: How Independent Can They Be?*

The multinational enterprise (MNE) minimizes the cost of doing business between the parent and its various subsidiaries by virtue of the common control exercised over all activities. This common control allows the MNE to allocate tasks to the subsidiaries: that is, to put it another way, to internalize international transactions in goods and finance, thereby reducing the so-called 'transaction costs'.[1] Thus the sale of components by the parent firm to the subsidiary does not require lengthy negotiations; it can be effected internally at the least cost by the parent's deciding who is to produce what product at what price. However, where control is not exercised by the parent alone, but is shared among the parent and its subsidiaries, these transaction costs may increase. The extent to which host-state rules can impose such transaction costs is limited. At some point, the parent firm will decide that it can no longer tolerate such increased costs arising from the subsidiary's control of decisions,[2] and will consequently close that subsidiary.

How Independent Are Foreign-Controlled Subsidiaries?

The 'intra-enterprise allocation' of decision-making power may be taken to mean that the parent allocates certain tasks or activities to the subsidiary. Where the parent makes all major business decisions, it will generally retain research and development (R&D) at

headquarters or, at least, will closely control the subsidiary's opportunity to innovate. While a recent report for the Conference Board[3] identified key MNE decisions, their locus, and their impact on the subsidiary's activities, it cautions against generalization because there are many different types of parent-subsidiary relationships. These types include, for example, those organized along geographic rather than product lines and those based on single or multiple product lines. Within each subsidiary, moreover, there may be a variety of business units, some of which may be more adaptable than others to increased autonomy in decision making. A simplified picture of the findings reported, which appears in Table 2-1, shows how independent subsidiaries are.

This study offers some general conclusions about the degree of autonomy desirable for a foreign-controlled subsidiary, although allowance must be made for variations in decision-making patterns according to the different types of company identified. First among

Table 2-1: *Extent of Subsidiary Independence*

Nature of Decision	*Activity*	*Usual Decision Makers*
Business operations	Product innovation	Subsidiary[a]
Capital	Purchase/sale of business	Parent
	Entering joint venture	Parent
	Building new plant	Parent
Labour and external relations	Negotiating labour contracts	Subsidiary
	Negotiating sensitive political issues	Subsidiary
Key personnel	Selecting new chief executive officer	Parent
	Nominating directors	Parent
Territorial/jurisdictional	Entering new markets/countries	Parent
Miscellaneous	Establishing R&D facility	Parent

Note

a. Note, however, who usually decides on territorial/jurisdictional matters and on establishing R&D facilities.

the general conclusions reached is that local managers "have considerable independence to make [decisions about] business, labour and external relations, but they must all take their plans to the tight-fisted banker [the parent company] at home." Secondly, while the trend towards a greater degree of independence for the subsidiary favours entrepreneurship for local business decisions only, there is tight parental control over capital commitments and the territory in which the subsidiary may operate. Finally, it must be remembered that the exercise of decision-making authority depends to a great degree on the following factors:

- The persons involved and the particular situation
- Control over decisions, which may take the form of direct order, consultation and approval, veto, or passive ratification
- Local managers who may wish to involve headquarters in decisions even when they are not strictly required to do so.

The study also compared the degree of autonomy exercised by local managers in about fifteen foreign countries.[4] The findings show that a Canadian manager of a subsidiary is likely to have more authority than a manager in other countries studied. This high degree of autonomy exercised by the Canadian manager is somewhat curious, since the Canadian government's policies were increasingly raising concern among members of the Conference Board. This concern was based on the Canadian government's demands that research facilities and top management positions be provided for its own nationals. This seeming anomaly may be explained by two related factors. First, local autonomy is limited geographically, since it does not confer on the subsidiary the freedom to sell its product in any other jurisdiction or territory; nor does the local manager have the authority to establish an R&D facility. Secondly, there is the question of the degree of risk involved. Because of the size of the Canadian market, actions taken by a Canadian manager often involve less risk of serious financial repercussions for the parent than do actions taken by, say, a German manager, whose marketing turf may cover the entire European Economic Community (EEC) or, indeed, the whole of Europe.

The contention, then, that Canadian subsidiaries are relatively autonomous is scarcely convincing. Generally speaking, the parent-subsidiary relationship in Canada has not yet evolved, as it has with a few of the larger European subsidiaries, from a 'parent-child' to a more equal relationship. Ford Motor (U.S.) and Ford Europe provide an example of the latter type of relationship, in which the increasing exchange of information, arising from improved communication systems, is leading to a better product, even though the

subsidiary operates autonomously.[5] Increased autonomy, it appears, may be perfectly compatible with improved communications. That this more equal relationship can emerge in an MNE even when the subsidiary's product may compete with that of a parent, at a time of increasing centralization of information at headquarters, attests to the possibility of limited 'product rivalry' between parent and subsidiary in certain situations. Internal competition, which occurs, for example, at 3M, Proctor & Gamble, Hewlett-Packard, Bloomingdale's and Tupperware, is seen as motivating 'corporate excellence'. Do these examples not serve to illustrate the potential for the effective *independent* operation of foreign subsidiaries in Canada?

How Independent Can Foreign-Controlled Subsidiaries Be?

The study mentioned above raises questions concerning the *actual* degree of independence exercised by foreign-controlled subsidiaries; it does not, moreover, address the *potential* degree of independence to be exercised by foreign-controlled subsidiaries. Table 2-2 shows the connection between the locus of key decision-making power and intra-enterprise allocation of tasks.[6] This table indicates, in a very general way, those decisions that the subsidiary may appropriately make, given the different forms of parent-subsidiary relationship. It illustrates the potential degree of independence that a subsidiary can exercise: the essential difference between the world product-mandate model and the Autonomous Subsidiary model is one of degree in the exercise of autonomy.

When we speak of the Autonomous Subsidiary or, more generally of increasing subsidiary autonomy, we have in mind a model in which key decisions relating to a significant proportion of output or products are made by the subsidiary; for Canadian General Electric (CGE), 40 per cent is the projected level. Other products may be the result of a more centralized (parent-directed) approach to decision making. The Autonomous Subsidiary exercises formal authority to make strategic business plans for an important part, if not all, of its output. It is not clear how many Canadian subsidiaries operating under a world product mandate really possess the formal authority to make strategic plans, although a 1983 paper prepared for the Conference Board has cited data to the effect that fully one-third of the larger Canadian subsidiaries have formal, annual, strategy-planning responsibilities.[7] Further research is needed along the line

Table 2-2: *MNE Structure and Control Over Decision Making*

Structure	*Production*	*Marketing*	*Product Renewal*	*Exporting*	*Key Personnel/ Capital Expenditures*
Miniature replica	Subsidiary	Parent to grant subsidiary autonomy for domestic market only	Parent	N.A.[a]	Parent
Product rationalization	Subsidiary	Parent	Parent	Parent	Parent
World product mandate	Subsidiary	Initial grant of mandate earned by subsidiary; subsidiary decision thereafter	Subsidiary	Subsidiary	Parent
Autonomous	Subsidiary	Joint parent/subsidiary initially; subsidiary decision thereafter	Subsidiary	Subsidiary	Joint parent/ subsidiary

Note

a. Not applicable.

of work referred to in that paper in order to establish criteria for identifying degrees of independence that form the spectrum of autonomous parent-subsidiary relationships.

If we relate Table 2-2 to the classification dealt with earlier, we find that the subsidiary can be more independent than the earlier material indicated. Table 2-2 indicates that in a subsidiary model with a higher degree of autonomy:

- Marketing decisions, which include establishing territories and jurisdictions, would initially be shared by parent and subsidiary, rather than made by the parent alone.
- Decisions relating to product-renewal activities, which would include establishment of R&D facilities, would become a subsidiary responsibility, rather than a parental one.
- Decisions about capital expenditures, which are now taken exclusively by the parent, would be made jointly, under an Autonomous Subsidiary model, with the subsidiary initiating the strategic planning.

Decentralized subsidiaries can gain efficiencies of scale, and Canada should be able to attract and maintain this form of business organization because it provides:

- A well-educated and highly trained labour force
- A sophisticated service economy, especially in financial and capital markets
- An extensive transportation and communication infrastructure
- A political stability not characteristic of many other jurisdictions
- A relative abundance of increasingly scarce energy and other raw material resources
- A sufficiently strong domestic demand in certain specialized sectors, and a demonstrated capability and expertise from which to build international markets.[8]

World Product Mandates and Increased Subsidiary Autonomy

As some information is now being gathered about subsidiaries operating under world product mandates, we direct our attention to investigating this subsidiary model rather than the Autonomous Subsidiary. World product mandates involve the granting of end-product responsibility to the subsidiary, including responsibility for R&D, production, and marketing world wide or in large geographic areas.[9] They require that the subsidiary retain decision-making

authority over product renewal — or over decisions as to which products to develop and bring to market — which, in turn, requires an in-house R&D capacity.[10]

Canadian General Electric Co. Ltd. expects that by the mid-1980s, 40 per cent of its Canadian output will be sold competitively on world markets. Rapid and sustained sales growth has been found to occur as a direct result of a conversion to world product mandates, although the risks of an internationally based market cannot be ignored. Export-led sales growth, in turn, has been shown, in a number of instances, to generate increased employment, large capital expenditures, significant R&D activity, and substantial export earnings, as well as a greater diffusion in Canada of technological capability.[11] Such results are attributable to the ability of the subsidiary to adapt to rapidly changing conditions, and this ability, in turn, arises from the subsidiary's control over decision making, from product design to world-wide marketing of a limited range of products. There is, of course, a prior decision that the parent takes, together with its subsidiary, in allocating world product mandates, but once the mandate has been assigned, it is the subsidiary's responsibility to make it a success. The assignment of particular products to the subsidiary is a function of the subsidiary's negotiating strength in relation to the parent. This strength arises, in part, from the attitude created in house: delegated authority and responsibility foster an autonomy and a 'need to survive' mentality which may motivate the management of that subsidiary to acquire as large a degree of control as possible.[12] The benefits arising from this form of business organization point up the reason why public policy should be directed towards fostering the increased autonomy of subsidiaries.

The Modest Number of Subsidiaries with World Product Mandates

World product mandates involve a voluntary devolution of decision-making authority. But such voluntary devolution has gone only so far, both in number of subsidiaries that have so benefited and in the extent to which individual subsidiaries have earned such mandates for a variety of products. Indeed, the number of Canadian subsidiaries operating under world product mandates is modest.[13] The reason for this modest number may be that while subsidiaries operating under such mandates should be more profitable in their own right, and the economies of specialization should be more profitable

to the MNE world wide, increased profitability is a *future possibility* in return for which the MNE is being asked to make a *present commitment* to what could be a transformation of its internal structure that could carry immediate costs and risks. There is no pressing reason for the parent to transfer to its Canadian subsidiary a mandate for those products in which the parent firm itself or another subsidiary has built a substantial stake. Similarly, the parent may want to retain at headquarters control of those new products that are in the forefront of new technologies, or it may not have sufficiently strong reasons to grant control to the Canadian subsidiary. These reasons, some organizational tradition, and a degree of inertia may account for the modest numbers of subsidiaries that have been assigned world product mandates. On the other hand, as the organization of international business becomes increasingly specialized, many more opportunities will become available to the subsidiary.

Is it reasonable, then, to expect the parent *voluntarily* to devolve such decision-making authority upon its foreign subsidiaries? Or is it sufficient to rely solely upon incentives and government-procurement programs to bring about this change-over? It has been suggested that some 'compelling reason' is necessary to induce parents to allow their subsidiaries to innovate — an essential feature of an autonomous subsidiary — on an important scale.[14] The comment has also been made, in the same vein, that "the problem is that little economic pressure exists to bring [such changes] about".[15]

A different view maintains that it is bad economics to try to create innovative subsidiaries. The subsidiary should support the parent's centralized R&D function, and no more.[16] This view is consistent with the traditional arguments for locating all R&D functions in one place: that is, to achieve savings, and to support senior management's 'need to know' costs and results so that losses associated with risky R&D can be cut. The simple answer to this thesis is that it appears to ignore the trend towards increased specialization of international production supplemented by decentralized innovative capacity. Existing mandates, albeit limited in number, supply evidence of this trend, as does their success to date. Moreover, this last contention does not appear to satisfy the public policy objectives previously elaborated.

What has been missing to date in the public policy context is the 'compelling reason' to encourage this change-over to world product mandates or the Autonomous Subsidiary model,[17] although the federal and some provincial governments encourage the allocation of world product mandates. Officials of the Department of Regional and Industrial Expansion (DRIE), for example, actively promote

these mandates in many sectors, and the Foreign Investment Review Agency (FIRA) generally views them as of significant benefit to Canada, and has actively pursued them. That the autonomy of subsidiaries is consistent with specialization, and that the parent can benefit from a two-way flow of technology are premises that have not yet constituted sufficiently compelling reasons to encourage this change-over. Hence an approach is needed that is based on a new reliance on laws of general application or on independent directors that seek to promote an autonomous subsidiary interest. Incentives alone or combined with reduced tariffs cannot be expected to produce the desired result in an international environment where competing 'carrots' abound. Governments of other countries in which an MNE operates may bring pressure to bear on the enterprise to produce more goods locally.[18] In addition, the MNE views the world as one market and might, for one reason or another, be willing to sacrifice profits in one country. Moreover, increased productivity arising from specialization is not necessarily coupled with an increased innovative capacity of a Canadian subsidiary.

International Experience

One should not lose sight of international efforts to increase the autonomy of the subsidiary. During the last decade, the development of codes of conduct to influence MNE activity has supported decentralized decision making. The Code of Conduct on Multinational Enterprises put forward in 1976 by the Organisation for Economic Co-operation and Development (OECD) states that MNEs should "allow their component entities freedom to develop and exploit their competitive advantage in domestic and foreign markets, consistent with the need for specialization and sound commercial practice." Such a provision begs a number of questions as between the parent and its subsidiary:

- How is competitive advantage to be fostered?
- Who is to decide the need for specialization?
- What is sound commercial practice?

A Code of Conduct on Restrictive Business Practices put forward by the United Nations Conference on Trade and Development (UNCTAD) provides that enterprises (that is, parent companies) should refrain from limiting their subsidiaries' access to markets for other than legitimate purposes. Again, who is to decide — and how — what constitute 'legitimate purposes'? Nevertheless, this and

other United Nations codes of conduct and, more important, the method of their development, represent an increasing awareness and acceptance by all states and the MNEs, as well, of increasing subsidiary autonomy.

Other countries also push for increasing delegation of decision-making authority, particularly in the areas of personnel and business-oriented decisions, including the establishment of R&D facilities. France, for example (together with Canada), ranks second to India in the number of reported requests to set up such facilities.[19]

What we may conclude, then, is that while the current parent-subsidiary models may give the appearance of decentralized MNEs, this description raises questions and demonstrates a situation that remains far from the Autonomous Subsidiary or world product-market models, or the possibilities that are discussed in the next chapter. That chapter looks at the characteristics of the autonomous subsidiary model and the public benefits to Canada associated with its promotion.

Notes

1. A.M. Rugman, *Inside the Multinationals: The Economics of Internal Markets*, and O.E. Williamson, "The Economics of Anti-Trust: Transaction Cost Considerations", p. 1439. In addition to benefiting by efficiencies arising from reduced transaction costs, MNEs also take advantage of imperfections in international markets and the tax rules in different countries.
2. Whether MNEs would be significantly deterred from creating or expanding subsidiaries if they were faced with less of control over certain decisions, such as the buying and selling practices of those subsidiaries, has been raised by J. Davidow. See J. Davidow, "The United States, Developing Countries and the Issue of Intra-Enterprise Agreements", p. 513.
3. R.E. Berenheim, *Operating Foreign Subsidiaries: How Independent Can They Be?*
4. *Ibid.*, p. 33, Table 13: Degree of Autonomy of Local Managers in Foreign Countries.
5. D. Tinnin, "Ford Is On a Roll in Europe", pp. 182 and 191.
6. See H. Crookell and J. Caliendo, "International Competitiveness and the Structure of Secondary Industry in Canada", p. 58. Table 2-2 has been developed from the Crookell study.
7. M.B.E. Clarkson, "Working Together: The Parent-Subsidiary Board Relationship".

8. H.P. Bones, "Are Foreign Subsidiaries More Innovative?", p. 20.

9. A cautionary note on the definition of world product mandates has been offered by the Ontario Advisory Committee on Global Product Mandating in its Report:

> [In] a *pure* global product mandating strategy, the affiliate is assigned *total* responsibility for particular products or operations within the multinational. This concept implies responsibility for all aspects of research and development, including conceptual or basic research; responsibility for manufacturing; and direct responsibility for international marketing. (P. 3. Emphasis in original.)

There is no such thing as a totally independent subsidiary, nor can there be total decentralization. Even a 'pure' product-mandating strategy does not mean total independence. One measure of autonomy or delegation of decision-making authority is the strategic planning authority of the subsidiary: see further note 13, below. The Advisory Committee referred to variations from this 'pure' world product-mandate strategy:

> For example, although some research and development for particular products may be done by the affiliate, an enormous pool of technology is usually available from the parent. This technology is often essential to the success of any product strategy. Access to this technology therefore represents a tremendous advantage to the affiliate and to the host country in which it operates. (*Report*, p. 3.)

As will be noted in Chapter 3, below, it is not the import of technology, but rather the opportunity to develop an innovative capacity that is a crucial activity. Thus the import of technology from the parent or a third party is consistent with the world product-mandate strategy as presented in this paper.

> At the same time, many MNEs are organized with markets and/or products already assigned to other affiliates. In other words, the established marketing patterns of the firm have already reserved defined geographic territories and/or specific products for sister affiliates located in other countries. (*Ibid.*)

Territorial restrictions would generally not be consistent with a world product-mandate strategy as described in this paper; however, certain limitations may be inevitable, whereby some of the supporting research and development (R&D) and marketing responsibilities are retained by the parent or sister affiliates.

10. A study of four MNEs operating under world product mandates showed that each subsidiary had experienced rapid sales growth in recent years, principally because of in-house development of new

product lines, rather than through a significant increase in sales of existing products. See Science Council of Canada, Working Group on Industrial Policies, *Multinational and Industrial Strategy*, p. 71.

11. *Ibid.*, pp. 68, 70.

12. I. Feltham, "Remarks to the Conference on World Product Mandating". Among the factors noted by Feltham which contribute to world product mandates are: diversity in product range of the MNE; a narrow market scope of a particular product; the extent to which the required factors or conditions critical to success have been developed in, or can be transferred to, the Canadian subsidiary; and the management structure and style of the subsidiary and its relation to its parent.

13. There are, of course, problems of definition in measuring the number of subsidiaries operating under world product mandates or the extent to which units of subisidiaries or product divisions are organized on a world product-mandate model. One measurement approach, noted in the study made by Professor D'Cruz of the forty-seven largest Canadian subsidiaries, was to distinguish among four types of subsidiaries, categorizing them in an ascending order of planning maturity and sophistication. These firms were distinguished as:

    Type I: No formal business planning for Canadian operations.
    Type II: Annual operating plans, but no strategic planning.
    Type III: Annual operating plans, with some strategic planning.
    Type IV: Formal annual and strategic planning, i.e., key strategic decisions are made in Canada, with participation in, and interaction with, the parent's strategic planning process.

    Approximately one-third of the sample companies belonged to Type IV; they were characterized by formal, annual, planning systems and 'made in Canada' decision making. See Clarkson, "Working Together".

    Other, less-precise measurements provide quite different statistics. One estimate was that less than 5% of most subsidiaries' activities derive from world product mandates. S. Goldenberg, "Specializing at the branch plant: Ottawa wants multinationals to give product rights to Canadian subs".

14. R. Vernon, *Storm over the Multinationals: The Real Issues*, pp. 44–45.

15. Crookell and Calieudo, "International Competitiveness", p. 62. "If immediate economic advantage is to be the chief criterion, the world product mandate has a bleak future." (p. 63.)

16. Rugman, *Inside the Multinationals*, p. 136.

17. D. Rutenberg, "Global Product Mandating": "The Canadian government has no *formal* policy of encouraging global product mandates, but does so in the process of encouraging the Canadianization of decision-making."

18. Host states' 'carrots and sticks' have a powerful effect — to the extent that they do not cancel one another out — on flows of investment and

trade. A recent study, made by the U.S. Commerce Department, of host-state competition for, and controls on, MNE investment shows that 26% received at least one incentive to invest, 20% were offered tax breaks, 8% were offered tariff concessions, and 9% were paid investment subsidies. Canada gave incentives to approximately 19% of U.S. subsidiaries (as compared with 33% for each of Britain, Sweden and Australia).

19. Berenbeim, *Operating Foreign Subsidiaries*.

3: *Characteristics of Increased Subsidiary Autonomy*

In the last chapter, we assessed findings of subsidiary independence and found the subsidiary's autonomy in decision making to be wanting in many respects. In this chapter we look to what should be the essential characteristics of subsidiary autonomy. By comparing the 'reality' with the 'ideal', we can extrapolate the essential activities and corresponding decision-making power for subdsidiaries.

The 'Reality' as Compared to the 'Ideal'

The 'Reality'	**The 'Ideal'**
• Limited subsidiary responsibility for production and marketing in host state	• Autonomous responsibility for most activities
• Access to limited geographical market area, such as Canada	• Access to international markets
• Broad range of products and standardized production	• Limited product line (specialization) and flexible manufacturing systems
• Research and development (R&D) at headquarters	• Subsidiary with innovative capacity
• Purchasing of intermediate products from parent or other affiliates.	• Greater freedom of choice in procurement.

The left-hand column describes the traditional situation where the parent company retains a large measure of decision-making authority over the subsidiary in the matters of where to sell (markets), product renewal (innovation), capital expenditures, and so on. Normally the subsidiary is left with control over adaptation of products to local market conditions (involving a modest amount of R&D), production, local marketing and distribution. Technology is often imported from the parent and adapted to local market conditions. It is not the import of technology, but rather the control and limitation on the use of imported technology that is characteristic of parental decision making.

By contrast, the right-hand column indicates much greater opportunity to build an innovative capacity without limitation on markets. Of course, this freedom may create intra-enterprise friction relating to responsibility for certain products and the potential for competition (that is, product rivalry) between parent and subsidiary. These issues will be addressed. The difference in activities listed in the two columns can be accounted for by the locus of decision-making authority: of the parent and subsidiary, which 'calls the shots'?

The right-hand column is preferred in the public policy context because the subsidiary model it represents stands for developing a competitive advantage in international markets. What is more, this model fosters technological advance and industrial transformation, which are the essence of increased productivity and, hence, of growth and development for Canada. However, as we noted previously, *in the absence of some compelling reason*, the global objectives of the multinational enterprise (MNE) may not always support the autonomous interest of the subsidiary. Although this internationally competitive subsidiary should develop increased sales (and generally profits[1]), wider employment, higher labour skills, greater foreign exchange earnings and wider import substitution,[2] these advantages, when viewed from the host-state perspective, may not produce similar benefits for the MNE.

This advantage in the international market-place depends upon developing a distinctive product or process which would result in a more competitive price range. The characteristics of the subsidiary essential to such distinctive development are:

- Specialization for the international market-place
- Innovative capacity
- Marketing and enterpreneurial skills.

Specialization for the International Market-place

The branch plants in Canada attempted to emulate the American organization of production, but achieved a less efficient model. In the United States, "high-volume, scientifically managed industry, producing standardized goods, generated vast economies of scale and levels of wealth unparalleled in history".[3] According to the author of this statement, this standardized organization of production now threatens continued productivity and growth in the United States. The reason is that U.S. manufacturers are increasingly facing international competition, and goods are being produced wherever their production is cheapest. This means that now and for the future, the developing countries have become the 'second wave' — that is, low-technology producers — and their cheap labour allows them to discharge this function.

Industrialized countries are beginning to produce new or specialized products that have in common three features: their products are precision manufactured, custom tailored and technology driven. These countries share a highly skilled work-force and require that traditionally separate business functions (design-engineering, purchasing, manufacturing, distribution, marketing, sales) be merged into a highly integrated system that can respond quickly to new opportunities. In short, they are premised on flexible systems of production.[4] As the industrialized countries face international competition, subsidiaries will be able to seek production efficiency through two approaches to specialization: they may develop an innovative capacity or a capacity based on rationalized production. The Auto Pact offers an example of rationalized production on a continental basis. Its terms encourage large, efficient, production runs by rationalizing the automobile market for North America so that one model of Oldsmobile, for example, may be manufactured in Canada for sale throughout Canada and the United States, while another model is produced in the United States for sale throughout that country and Canada. But R&D for the Canadian-manufactured model is retained at headquarters in the United States, where key marketing decisions are also made. Thus the branch-plant mentality is retained, and the subsidiary's key decision-making powers remain truncated. There may be legitimate reasons, from the perspective of international competitiveness and productivity, for adopting a rationalized production model in this case; it should be recognized, however, that this truncation of decision making represents a serious constraint in creating the highly skilled jobs that a high-wage-rate country such as Canada must encourage. In fact, the organization of production in this way will lead to more

instances of job loss and lower wages for many workers in highly industrialized countries as mechanization and robotics displace workers.

At the other end of the spectrum, a flexible system of manufacturing in which human capital and innovation are the key ingredients of success provides an alternative approach to attaining production efficiency. This approach is not geared to the manufacture of goods suitable for large production runs; instead, it is a system geared to change and to instability. The *sine qua non* is the integration within the organization of key activities that can respond quickly to change. Plants operating under a flexible manufacturing system are described as follows:

> They consist of computer-controlled machining centers that sculpt complicated metal parts at high speed and with great reliability, robots that handle the parts, and remotely guided carts that deliver materials. The components are linked by electronic controls that dictate what will happen at each stage of the manufacturing sequence, even automatically replacing worn-out or broken drill bits and other implements.[5]

But this organization of production need not cause a greater degree of labour displacement. Specialty steel, special chemicals, synthetic fibres and precision-engineered automobiles, among other products, will require high-level skills because the problems and opportunities associated with their manufacture cannot be anticipated. It is this aspect of human capital that has been cited[6] as the distinguishing characteristic of this approach.

Industry has only become aware of flexible manufacturing systems within the past two years, and the success of these systems has so far been limited. The investment these systems require is large, and their financial return has been, in many cases, difficult to justify. But quick financial return, it has been argued, is not an appropriate measure by which to gauge the success of a flexible system of manufacturing. Because of its adaptability and flexibility, such a system offers what has been identified as a key factor of innovative companies: the ability to respond continually to change.[7] Recent examples of flexible systems' success stories include a reduction in product cost of 16 per cent, delivery cut to two weeks from six, and almost faultless quality. In another case, there was a 30 per cent reduction in the holdings of raw materials, work in progress was cut by 93 per cent, and there was a 65 per cent drop in the quantity of finished goods awaiting shipping. This is because a

flexible system makes products as they are called for, when they are needed, using facilities that are flexible enough to manufacture variants, or even other sets of similar components, for other products.

The flexible system's greatest potential for bringing about change lies in its capacity to manufacture goods cheaply in small quantities. Under such a system, economies of scale would no longer be the key to productivity gains. For a country the size of Canada, flexible manufacturing could enable subsidiaries to produce efficiently for the Canadian market first, and then build export markets from this base. While standardized production has shaped the organization of production in international trade and investment, its effect can be seen to be changing for foreign-controlled subsidiaries in industrialized countries such as Canada. A third model, apart from rationalized production and flexible manufacturing systems, relies on large-scale production of high-technology products under world product mandates. Standardized production of innovative products (at the beginning of the product life cycle) based on highly skilled labour would fall into this category. Whether the subsidiary operates under a flexible manufacturing system or relies on standardized production of innovative products, it is seen as a strategic business centre in its own right. Thus the organization of business and its forms of production may be seen to be coming together so that the absence of economies of scale need no longer be a limiting factor to locating specialized production in Canadian subsidiaries. These subsidiaries must be encouraged to foster specialized organization of production by increasing their opportunity to develop an innovative capacity and an entrepreneurial spirit. It may be that, as in many such situations, the result of change will be neither black nor white: some products or business units will follow a rationalization approach, while others will adopt world product mandates, with or without flexible manufacturing systems. Public policy should seek to encourage the latter development, while recognizing that both approaches may coexist within the same subsidiary, but in different business units or for different products.

Innovative Capacity

A recent study of what Canadian firms saw as the basis for their competitive advantage led to the conclusion that innovative technology was first and foremost; marketing skills ranked second. An important finding was that 80 per cent of respondents reported that

the source of competitive advantage was developed 'in house', which, in the terms of this paper, means within the subsidiary.[8] Thus in-house innovative technologies and marketing skills are essential ingredients to competitive advantage. Canadian subsidiaries have not performed as well as Canadian-owned enterprises in exporting product innovations because of their reliance on imported technology.[9] Since much of the subsidiary's technology depends on imports,[10] what are the public policy implications for improving the subsidiary's advantage in competitiveness?

The subsidiary can expand its innovative capacity by developing a new or improved product or process 'from scratch' or by importing the original R&D and developing an innovative product or process based on the imported technology. Imported technology, by itself, is not the problem; the problem lies in what happens to this technology once it is transferred to Canada. Japan built itself up on imported technology, but since the users were not foreign controlled, but were independent firms with the financial resources, size and markets to negotiate from strength, they were able to negotiate technology licences without serious limitations on use; thus they were able to make technological advances and to bring about industrial transformation, developments which are essential to increased productivity. In Japan most of the local scientific and technological effort is allocated, with massive public support, to those industries that have imported most foreign technology. "The import and adaptation, or creation, of knowledge [in Japan] complement each other."[11]

In Canada the supplier of the technology (that is, the parent company) often controls the importer of the technology (that is, the subsidiary), by imposing formal restrictions or limitations on the imported technology's use.[12] Unlike the Japanese model, in which imported technology served as the linchpin for innovative methods of production for international markets, Canada's imported technology has served as a basis for adapting production methods for the Canadian market.[13] The result is that imported technology has substituted, in many intances, for indigenous technological effort. The transfer of technology is most effective when it is absorbed by the receptor in such a way as to provide a spring-board for its move into the next stage of industrialization. Where the spring-board effect is denied the subsidiary, the constraint imposed by this denial must be addressed. In an increasingly specialized international market, the subsidiary cannot expect to continue, with impunity, merely to adapt technology imported from the parent. On the contrary, it will be required to pursue, where feasible, innovative research directed at foreign-market sales. Will it have the opportunity to devel-

op an innovative capability? The key to developing such a capability is the granting of freedom from restraints on developing its own technology and acquiring its own markets.

While the change-over to a production-efficiency model will allow subsidiaries to become more highly specialized and hence more efficient, it does not necessarily follow that the subsidiaries will develop an innovative capability. Public policy should encourage the development of this innovative capability lest the subsidiaries be reorganized along the rationalized production model. Greater attention is required to the removal of constraints and to the encouragement of innovative technology, from whatever source.

Marketing and Entrepreneurial Skills

A firm that is to succeed on the basis of holding world product mandates or, alternatively, of supplying small volumes of specialized products requires, in either case, marketing skills and entrepreneurial spirit so that it can move quickly to take advantage of opportunities. The difference between the typical chief executive officer of a foreign subsidiary and a domestic firm has been compared to the difference between a manager and an entrepreneur.

> Because Canada has so many branch plant operations, many Canadian presidents [of subsidiaries] are really the operating heads of companies that are implementors of somebody else's strategy. . . . They aren't really bosses — they report to somebody else. So research and development, initiating new projects, being entrepreneurial. . . they're not large requirements. You need the kind of person who can implement and doesn't have to create. You need management skills rather than creativity. I would say you don't need as much talent.[14]

Moreover, it cannot be over-emphasized that marketing is a driving force of most organizations and is intimately linked to innovative capacity. If the customers' special needs are to be recognized and met, designers must be familiar with the processes of fabrication, production, marketing and sales; and salespeople must understand their firm's capability to deliver new or customized products. *Complete integration of activities within the subsidiary* is essential to the successful implementation of a model that seeks production efficiency and that has the innovative capability to be able to respond to change of any sort in its environment. If such response is to occur, subsidiaries must possess autonomy in decision making.

Public Policy Context

Since the 1960s, government policy has supported the autonomous foreign-subsidiary model. It was then realized that the investment climate had encouraged the MNE to invest in Canada as a market seeker, and that, as a result, branch plants had proliferated. The Gray Report summed up the official concern over this development in its description of "truncated" subsidiaries:

> Foreign controlled firms do not seek to perform certain tasks in Canada, with the result that Canadian skills and capacities are not developed adequately to support foreign *or* Canadian controlled enterprises. This reliance on external sources for many of the inputs of industrial activity has meant a lesser development of Canadian capacities — and perhaps even a stultification of these capacities.
>
> But the essential point . . . is that truncated subsidiary operations usually lack the *capacity* and *opportunity* over time to develop the full range of activities normally associated with a mature business enterprise.[15]

The initial government response, in 1966, to the perceived threat of foreign investment was to issue voluntary guidelines of good corporate behaviour for foreign subsidiaries.[16] This good behaviour included increasing specialization on the part of the subsidiary; exposure of the subsidiary to international competition and export opportunities; and the subsidiary's development of an innovative capability. Again, in 1975, another set of voluntary guidelines was introduced.[17] These guidelines were an extension of the first set, and called upon subsidiaries to "pursue a high degree of autonomy in the exercise of decision-making and risk-taking functions" and to develop "an autonomous capability for technological innovation".

The Foreign Investment Review Agency (FIRA) was set up in 1973 as a consequence of the Gray Report; its purpose was to obtain performance undertakings from the MNEs, as a condition of permission to do business in Canada. Such performance undertakings might relate to employment, R&D, exports, domestic procurement, resource processing, ownership by Canadians, and impact on productivity and on competition. In seeking significant benefits, FIRA tries to obtain, among other performance undertakings, world product mandates for the subsidiary. The FIRA approach is, however, geared rather to measurable performance undertakings than to non-quantifiable commitments such as increased subsidiary

autonomy in decision making, which, I suggest, would ultimately lead to increased employment, R&D, exports, and so on. Hence, while public policy supports the autonomy of subsidiaries, the FIRA program itself does not focus on encouraging autonomy *per se*. It takes, instead, a different approach to the same end of increased growth and development for Canadian subsidiaries.

As part of this public policy debate, the Science Council, during the 1960s and 1970s, was advocating the principle of 'technological sovereignty', in which the development and control of technological capacity was seen as an objective in support of national sovereignty.[18] A study for the Science Council advocated that industry as a whole should become increasingly Canadian owned because the behaviour of multinational companies does not support the long-term aspirations of Canadians for their economy and society.[19] It concluded that increased support for Canadian technological sovereignty was warranted. By this it meant that national sovereignty required the development and control of an indigenous technological capability in those areas, such as housing and energy, that are essential to the Canadian physical environment; that possess geographical advantage for such projects as the development of the extraction and processing of natural resources, and of ocean and arctic technologies; that support national unity through such means as transportation and communications; and that historically can claim excellence in such fields as nuclear energy, electrical transmission and communications. This package amounted to what may be called 'technological Olympic Games', and it went far beyond the government's voluntary guidelines. A study for the Science Council assumed that all subsidiaries operated as branch plants, and if that assumption were correct, one could sympathize with the argument. However, with the emergence of world product mandates and their potential, which support the pursuit of a positive policy to influence the allocation of tasks between the parent and subsidiary, the assumption made by the Science Council is increasingly subject to question. It should be noted that in more recent publications, the Science Council has assessed the impact of world product mandates and has supported them.

In this chapter we have sought to develop a rationale to support the world product-mandate or Autonomous Subsidiary models, with or without flexible manufacturing systems, consistent with emerging trends in the organization of international business and of production within that business. Canada's public policy goals of increased growth and development can be supported by the foreign-owned subsidiary, provided that the latter is free to develop an

innovative capacity and entrepreneurial skills. Such objectives can be better attained by encouraging decentralization of decision making through increased subsidiary autonomy, since it is the lack of autonomy that inhibits opportunity for innovation and entrepreneurship.

Notes

1. A case-study of the relationship among profits, exports and technology concluded that subsidiaries that export more are more profitable than the miniature-replica plants, and that subsidiaries with world product mandates have a stronger technology base, which supports exports. See J.K. Carman, "Technology Transfer Within a Multinational: The Case of Westinghouse Canada Ltd.", p. 112.
2. Science Council of Canada, *Multinationals and Industrial Strategy*, Ch. 1, note 7.
3. R.B. Reich, *The Next American Frontier*.
4. *Ibid*. Emphasis added.
5. G. Bylinsky, "The Race to the Automatic Factory", p. 52.
6. Reich, *The Next American Frontier*.
7. T.J. Peters and R.H. Waterman, Jr., *In Search of Excellence: Lessons from America's Best-Run Companies*.
8. H. Crookell and J. Graham, "International Marketing and Canadian Industrial Strategy", p. 32.
9. In 1978, 68 per cent of the product innovations of Canadian-controlled firms were being exported as compared to 58 per cent for the foreign-controlled firms' product innovations. Differences between the two types of firm arise because of the *extremely poor export performance of product innovations based on externally acquired technology*. For recent data on imported and 'in-house' technology, see D.P. De Melto, K.E. McMullen, and R.M. Willis, *Preliminary Report: Innovation and Technological Change in Five Canadian Industries*. See also Canada, Ministry of State for Science and Technology (MOSST), *R&D in Canadian and Foreign-Controlled Manufacturing Firms*.
10. Imported technology accounts for an overwhelming percentage of the technology used in Canada. Most of this imported technology comes from the parent firm, often at little or no direct cost to the subsidiary. The amount of unrecorded or invisible inflow of R&D (all of which is assumed to be intra-enterprise) has been estimated by the Ministry of State for Science and Technology at $600 million per annum, a figure which approximates the total annual indigenous R&D expenditure by Canadian industry. While, on the one hand, this $600 million of R&D replaces domestic R&D effort, it is also an inexpensive way of acquiring

this R&D. (See A.R. Safarian, "Foreign Ownership and Industrial Behaviour: A Comment on 'The Weakest Link' ", note 18.) See Canada, MOSST, *Importation of Invisible Research and Development, 1974–76*, p. 6; MOSST, *Overview of Research and Development in Canada*. As H.P. Bones points out, when these 'invisibles' are taken into account, the divergence in R&D expenditures between subsidiaries and domestic firms disappears. See Bones, "Are foreign subsidiaries more innovative?", p. 20.

The small size of most Canadian markets, relative to the number of products and the size of production runs, has generally been viewed as insufficient to support extensive R&D programs. See H.E. English, "Industrial Organization and Technical Progress" pp. 131–32. This view is supported by the United States-based Strategic Planning Institute (SPI), its membership mainly composed of MNEs, which argues that high spending on R&D is a risky and usually unprofitable strategy, and that it may be more profitable to copy, when possible, than to innovate. The argument that a 'critical mass' of research outlays is needed to achieve a pay-off has been advanced to support the position that larger companies are generally better recipients of government-grant programs. But the fact that 80 per cent of all new employment during the 1970s was created by companies less than four years old and the fact that smaller companies are more innovative than larger ones do not support the 'critical mass' theory.

11. Junta del Acuerdo de Cartagena, *Andean Pact Technology Policies*, p. 8. This is not to say that Canada should attempt to, or would, emulate Japan. (See further, Bones, "Are foreign subsidiaries more innovative?".) But the point here is that Japan 'made it' on imported technology.

12. De Melto, McMullen and Willis, *Preliminary Report* p. 88 ff. and, in particular, pp. 108–109, 112, 115.

13. See Bones, "Are foreign subsidiaries more innovative?"

14. Douglas J. Tigert, as quoted in J. Ruddy, "What it Takes to be a Boss", p. 18.

15. Government of Canada, *Foreign Direct Investment in Canada*, p. 6. (Emphasis added.) See also p. 405 ff.

16. "Good Corporate Behaviour for Subsidiaries in Canada of Foreign Companies" (the so-called 'Winters Guidelines') is reprinted in Canada, Department of Industry, Trade and Commerce, *Foreign-Owned Subsidiaries in Canada: A Report on Operations and Financing by the Larger Subsidiary Companies, 1964–69*, pp. 53–55.

17. "Principles of International Business Conduct", (the so-called 'Gillespie Guidelines', 1975) is reprinted in *Facts for Businessmen: Foreign Investment Review Act*, pp. 12–13.

18. Josef Kates, as quoted in the Science Council of Canada, *Annual Report, 1976–77*, p. 26. However, Safarian and others have argued that there

was not a statistically significant difference between subsidiaries and independent firms with regard to exports and research expenditure. Safarian points out that two studies for the Royal Commission on Corporate Concentration more or less confirm his earlier findings on the relation between ownership and foreign trade, although McFethridge's study showed that in certain sectors, domestically owned firms spend more on R&D. See Safarian, "Foreign Ownership", p. 322. Other studies support the evidence of higher expenditures for R&D by Canadian-owned firms, but this has been explained by Bones, "Are foreign subsidiaries more innovative?".

19. Britton and Gilmour, "The Weakest Link".

4: *Approaches to Strengthening Foreign Subsidiaries*

Because foreign subsidiaries occupy such a large place in the secondary manufacturing sector, their continued growth and development is in Canada's national interest. As we have seen, export-led sales growth has been shown to generate increased employment, large capital expenditures, significant research and development (R&D) activity, substantial export earnings, and greater diffusion within Canada of technological capacity. Hence, foreign-owned subsidiaries can be strengthened by encouraging their international competitiveness as production-efficiency seekers. Their development can be achieved through different approaches, some of which have been advanced in previous official reports.

Four reports, covering a whole range of adverse consequences believed to arise from foreign investment, were submitted to Canada's federal government between 1957 and 1972. The most salient of these consequences were low productivity of manufacturing firms in Canada and the threat of foreign domination of the Canadian economy. The Gray Report, published in 1972, diagnosed the problem as arising from foreign control, not foreign ownership. This distinction had important policy implications: it was foreign control over decision making that was recognized as a particular problem, rather than foreign ownership. This problem was addressed by obtaining undertakings from foreign owners that subsidiaries were to perform in a manner that would produce significant benefits for Canada. The Gray Report, in effect, recognized that control over decision making remained with the parent company, but it advocated exacting performance undertakings whereby an

MNE would have to concede certain activities to its Canadian subsidiary.

The other reports focused more on the adverse consequences of foreign ownership and, consequently, dealt with the ownership structure or the advantages of merging various businesses, including subsidiaries, to form larger and stronger units. In 1957 the Gordon Commission recommended the issue to Canadians of a sizeable minority share of equity in stock in foreign-owned subsidiaries. The Wahn Committee believed that the Canadian-owned equity share should comprise at least 51 per cent of the voting stock. The Watkins Report recommended encouraging increased rationalization of Canadian industries, including foreign-controlled subsidiaries, through mergers and acquisitions.

There has been little discussion of ways to encourage the devolution of decision-making power to the subsidiary. It was assumed that control over decision making rightly resided with the parent company. However, the absoluteness of this right has been challenged by the statement: "The difficulty will continue so long as we adhere to the *principle that a parent firm is entitled to direct the policies of its subsidiaries*."[1]

Three ways of strengthening a subsidiary's competitiveness are discussed in this chapter. In addition to reviewing the FIRA method of performance undertakings and an approach based on the performance of a firm, without distinguishing the nationality of its owners, we shall examine the approach of encouraging increased subsidiary autonomy in decision making by limiting the principle that a parent company is entitled to make the decisions for, and direct the policies of, its subsidiaries.

The Foreign Investment Review Agency (FIRA)

The Government of Canada, as is its right under international law, screens foreign investment entering our country. It asks two questions:

- Is the firm that is seeking to invest in Canada foreign controlled?
- If it is, will its business activity provide significant benefits for Canada?

The definition of 'foreign control' is based on control in fact, that is, who 'calls the shots', not legal control, that is, who owns 51 per cent of the voting shares.[2] The Gray Report concluded that control in fact, that is, control over key decisions, was the important feature of

foreign investment and was, therefore, the feature to be regulated. This regulation took the form of screening foreign-controlled investment: whether the foreign investment was to be allowed or disallowed was based on performance commitments to provide significant benefits for Canada. It is this aspect of the FIRA process that has drawn much criticism on the grounds that it is highly discretionary and lacks objective criteria adequate to ascertain the 'rules of the game'. The process often involves negotiation of these performance undertakings by a multinational enterprise (MNE) and FIRA officials. What type of undertaking guarantees significant benefits for Canada is only very generally set out in section 2(2) of the FIR Act, though the matter has been somewhat elaborated in voluntary guidelines for foreign-controlled subsidiaries. The undertakings may include capital investment, employment commitments, location, R&D, or export agreements.

The FIRA process has attracted considerable criticism on the ground that:

- It is viewed as a costly sharing of the MNE's decision-making power with Canadian government officials.[3] The costs arise from delayed decisions and administration.
- There have been negative reactions to FIRA's monitoring of these undertakings.
- Some provinces have expressed dissatisfaction about the barring of foreign investment that did not meet FIRA's test.
- International dissatisfaction has been registered with respect to performance requirements exacted by FIRA during the negotiations with MNEs.[4]
- Domestic procurement undertakings were recently held to be contrary to the General Agreement on Tariffs and Trade (GATT). Further, perception of non-enforcement of other undertakings may affect the program's credibility.

It is maintained, however, that these negotiated terms of entry give rise to tangible economic and public interest advantages for foreign-controlled interests, and one would not wish to abandon these advantages without some certainty of a continued flow of significant benefits to Canada.[5]

In the final analysis, though, apart from the vagueness of the rules and their associated costs, the FIRA process does not address the real problem that 'control in fact' resides with a foreign decision maker. Continued parental control over decision making is implicitly a part of the FIRA process. If FIRA were to deal with the cause of this problem, it would seek to transfer control over certain

decisions from the parent to the subsidiary. Thus FIRA addresses not causes, but symptoms and associated behaviour.

Non-Discriminatory Model

Senior executives from a few foreign-controlled subsidiaries in Canada have proposed dismantling FIRA. In their view, all that is important is how well a business performs. The Advisory Committee on Global Product Mandating recently concluded that:

> Governments can influence more multinationals to evolve to specialized missions (or world product mandates) in their Canadian operations. They can also contribute to the ability of affiliates to compete for attractive specialized missions. The most effective way to achieve these objectives is to emphasize *performance* rather than *ownership* of the multinational affiliate.[6]

Under this approach, government incentives, export support and procurement programs would be used to benefit both subsidiaries and Canadian firms, depending on how well these were performing in relation to previously identified national objectives. Ownership or control would not be a factor. Those subsidiaries that develop export markets would be entitled to the benefits of whatever program was appropriate, as would any other enterprise that performed equally well.

The Advisory Committee's recommendations were aimed at encouraging world product mandates and thereby encouraging the change-over from 'market seeker' to 'production-efficiency seeker'. The Committee believed that if proper incentives existed, the marketplace would dictate the grant of these mandates to the subsidiary. It implicitly assumed a state of competition in which the MNE is an efficient allocator of resources. But the MNE views the world as one market and might sacrifice profits in one country if this action meant building a stronger operation world wide. Thus, even though the MNE might be an efficient allocator of resources world wide, it does not necessarily follow that its Canadian subsidiary would become internationally competitive, along the lines discussed here.

A reduction in tariffs may further support this non-discriminatory model. If, by 1987, there is a further general decline in tariffs of about 40 per cent, the resulting level of Canadian tariffs may well be less in certain industries than the difference between

cost of production in Canada and the United States. This will mean that Canadian manufacturers must be increasingly competitive on a global basis if they are to remain viable. It could, then, be cheaper, in some cases, for the parent firm to export to Canada rather than to continue manufacturing here in a 'branch plant'. However, it is reasonable to expect that with freer trade, subsidiaries would specialize and seek world-wide markets or would increasingly rationalize production along the lines of the Auto Pact for a North American or world-wide market. But many subsidiaries lack an innovative capacity and an entrepreneurial spirit of independence and aggressiveness in making decisions and taking risks in their own right, and these factors are often critical to business success. Thus, continued foreign control over decision making in the subsidiary's activities does not augur well for a successful change-over from the market-seeker model to the proposed production-efficiency model.

Even if reduced tariffs spurred parents to grant world product markets to their subsidiaries, the nature and extent of these mandates would remain a source of concern. Competition among states for investment by MNEs, in a world of reduced tariffs, does not allow us to conclude that a performance model would adequately respond to Canada's interests. However, to the extent that an autonomous subsidiary interest is recognized, it would follow that non-discriminatory incentives or other 'carrots' should be made available to all business in Canada.

Autonomous Decision-Making Model

The current approach to foreign investment has sought to affect the conduct, behaviour or performance of subsidiaries, while leaving in place the basic structure of the MNEs, that is, parental ownership of shares and parental control over decision making. The approach proposed in this paper seeks to effect a change in control over decision making while, at the same time, reducing direct government intervention. Such an approach is, however, at variance with traditional views of the parent-subsidiary relationship, since it questions the principle that a parent firm is entitled to direct the policies of its subsidiaries.

On parental control, the Royal Commission on Corporate Concentration found that:

> . . . the interests of the subsidiary are normally identical with the interests of the parent shareholder. Transactions may be

> carried out between the parent and the subsidiary . . . , but the shareholder need be concerned only with its own interests because there are no other shareholders. For example, assets may be transferred back and forth with relative ease. It is clear that this situation provides (subject to creditors' rights) great flexibility to the parent in dealing with the subsidiary, its business and its assets.[7]

It is fair to say that Canadian company, competition and other laws are supportive of this principle. But the Commissioners balked at the notion of absolute parental discretion in exercising decision-making control over a subsidiary. On the composition of boards of directors of subsidiaries, they cautioned:

> Where subsidiaries are sizable, and in particular when they are also foreign-owned, we think, however, that such boards should have outside members for the same reasons that apply to other large corporations.[8]

The proposal to increase subsidiary autonomy in decision making has two components. On the one hand, laws of general application may insulate the subsidiary from the parent's decision-making power and influence the parent to devolve greater decision-making authority upon the subsidiary. On the other hand, the directors' responsibility to monitor and supervise the subsidiary's affairs in its best interests may be clarified to take into account the protection of an autonomous subsidiary interest.

As to the need to insulate the subsidiary from the parent:

> Canada must find some way of *developing laws prohibiting the Canadian affiliate from carrying out the directives of the parent that have anti-competitive effects*, where the action of the Canadian subsidiary does not of itself constitute a breach of the Canadian legislation.[9]

This comment was made in connection with decisions taken by the foreign parent which have anti-competitive effects within a firm. One means of coping with internal restrictive arrangements could be the adoption of the tenet that a foreign parent and its Canadian subsidiary could be guilty of conspiring with each other. This would involve taking the position, under the Combines Investigation Act, that internal restrictive arrangements between parent company and subsidiary create, in fact, two separate entities, and that these sepa-

rate entities could conspire. While this position offers the possibility of prohibiting Canadian subsidiaries from implementing foreign directives, it is not adopted here.

Yet, a government seeking to restrict the effects of an MNE's operations, as carried out by parent or subsidiary, must somehow reach the real decision makers: *"How any country can reach the most senior levels of management in terms of influencing the behaviour of that level of management* is an important and integral aspect of the study of the MNE."[10] Further:

> *Governments* desiring to control the business operations of MNEs must *direct their legal commands to that component of the MNE that is empowered to respond* — the place where the effective control lies with respect to the *particular issue* under consideration. . . .[11]

It remains, then, to explain in the next chapter how the host state can protect the subsidiary from the parent's disadvantageous instructions, through supportive legislation and through clarification of directors' responsibilities.

Notes

1. D.H.W. Henry, "Anti-Monopoly Legislation in Canada", p. 327. Emphasis added.
2. A test of 'control in fact' seeks to establish who really makes the decisions, whether in virtue of ownership of shares, of expertise, of contract or of any other factor. For example, where a foreign shareholder owns a significant minority interest in a company, let us say 30%, and the remaining 70% is widely held by Canadians, a strong case can be made that this company is foreign controlled. This would be so even if the board of directors and management personnel were Canadians. The controlling shareholder normally exercises control, partly by ensuring that the board members are acceptable to it and partly by arranging for the appointment of senior management personnel compatible with the controller's views and objectives. In a proxy fight, the largest shareholder is in a commanding position to determine ultimate control.
3. See L.Y. Doz and C.K. Prahalad, "How MNCs cope with host government intervention", pp. 150—51.
4. R.D. Hormats, "New Challenges in International Investment Policy". See also M. Rashish, "North American Economic Relations".

5. An added advantage of the FIRA-type process is its ability to monitor the undertakings and, in extreme cases, even to render the investment 'nugatory' or to revoke permission to carry on business. The proposal in this paper depends on delegation of autonomy in decision making to the subsidiary. But since the parent could maintain influence over the subsidiary, it is possible that this autonomy could be theoretical, or that it could be revoked or amended by the parent. There remains some need to monitor the relationship, as well as need for a sanction to prevent a parent from influencing the subsidiary's autonomy in decision making once that autonomy is granted. In a self-regulating system, such monitoring could be the responsibility of the board of directors. Depending on the choice of machinery for implementation, such sanctions could range from extra-territorial reach to the parent company to loss of incentives to the subsidiary, where applicable, or to fines.
6. Ontario Advisory Committee on Global Product Mandating. *Report*, p. 7. Emphasis in original.
7. Royal Commission on Corporate Concentration, *Report*, p. 306.
8. *Ibid.*, p. 296.
9. Henry, "Anti-Monopoly Legislation", p. 327. Emphasis added.
10. I.R. Feltham and W.R. Rauenbush, "Canada and the Multinational Enterprise", p. 44. Emphasis added.
11. Y. Hadari, "The Structure of the Private Multinational Enterprise", p. 751. Emphasis in original.

5: *A New Policy towards MNEs*

In most states that are members of the Organisation for Economic Co-operation and Development (OECD), the interests of autonomous subsidiaries are becoming increasingly recognized, both in law and in the courts, in fields such as competition and company law. In Canada such recognition has lagged, and there is scope for our laws to provide further protection for interests of autonomous subsidiaries in a way that would replace the present discretionary screening activity of government.

Protecting Subsidiary Autonomy

Most OECD-member states have laws that protect a subsidiary's creditors and minority shareholders, as well as laws that are the focus of this paper: that is, those that protect a subsidiary's autonomous interest as an ongoing business. Protection of creditors and shareholders is achieved by imposing on the parent company financial responsibility for the consequences of those activities of the subsidiary that the parent directs. In theory, this responsibility could inhibit the extent to which a parent interferes with its subsidiary's autonomy. In practice, however, it has only a limited effect, and legislation that is specifically intended to protect the interest of an autonomous subsidiary has also been required.

First, what is meant by 'protecting the autonomous interest of the subsidiary'? There is a theory in civil law that illustrates this concept: it recognizes that a legitimate right can be abused. For ex-

ample, you may be abusing your right to erect a fence to separate your property from your neighbour's if you build the fence twelve feet high! Your right impinges on your neighbour's right to the enjoyment of his property. In that case there are competing rights which the law seeks to protect by limiting one of them. By analogy, the parent company has a right to make decisions for its subsidiary by instructing the subsidiary's management. Recognizing the interest of an autonomous subsidiary implies limiting the right of the parent to make *all* decisions for the subsidiary. In this paper, such total control by a parent of its subsidiary may be termed an 'intra-enterprise abuse'. The theory which I propose to eliminate this abuse, I shall call the 'intra-enterprise-abuse theory'.

The rationale for this proposed intra-enterprise-abuse theory can be found in a decision of the French courts, taken some twenty years ago in the Freuhauf case.[1] This case, which is textbook material for international law students, illustrates the potential extent of parental abuse of a subsidiary's autonomous interests. The parent, located in the United States, ordered its French subsidiary to cancel a large truck order from China because the transaction violated the U.S. Trading with the Enemy Act, which applied extraterritorially to U.S. subsidiaries abroad. The French courts appointed an administrator to administer the subsidiary provisionally and to execute the contract with China because the parent's directive was of no benefit to the subsidiary. In fact, the cancellation of the order for trucks could have led to the subsidiary's bankruptcy. This is an extreme example of intra-enterprise abuse. More recently, the United States exerted similar pressures on its multinational enterprises (MNEs) not to allow the export of materials to construct the Soviet gas pipeline into Europe.

The French court's reasoning in the Freuhauf case contains the foundation of an abuse theory that could have wide application. It described the French subsidiary as "an independent cell" having "a certain place in the economic ensemble of the country, which implies certain duties and social obligations." The court decided to take into account "the interests of the [subsidiary] rather than the personal interests of the shareholders [the parent company] even if they be the majority." Given such a concept of the subsidiary as a separate entity, the subsidiary will have certain duties and social obligations to its host state, which may differ from those it owes to the parent. The Freuhauf decision recognizes subsidiary interests separate from those of the parent and provides a basis for the theory that any decision by the parent which is contrary to the subsidiary's interests constitutes an abuse.

While Canada has faced similar instances of foreign legal directives affecting the affairs of Canadian subsidiaries, these differences have been settled without recourse to court intervention. The Combines Investigation Act now prohibits a Canadian subsidiary from implementing an anti-competitive foreign directive or one issued pursuant to a foreign law. But no Canadian law or court has gone as far as the French court in the Freuhauf case in adopting an intra-enterprise-abuse theory, or in extending the notion of an autonomous subsidiary interest beyond these very limited provisions in the Combines Investigation Act. Both the Fruehauf decision and the Combines Investigation Act start from the same premise; the main difference is that the former was a court decision which gave a wide interpretation to general principles of the French legal system, and the latter is a limited provision of a statute.

The implementation of the OECD Guidelines for MNEs raised a question whether parent companies should, in certain cases, assume financial obligations of a subsidiary, even though the subsidiary is a separate legal entity. Such an undertaking has been referred to 'as the protection of the subsidiary's creditors and minority shareholders'. In 1979 a Committee of the OECD concluded that a parent might assume such responsibility in special circumstances. This conclusion led to a subsequent OECD study and report, tabled in 1980, entitled "Responsibility of Parent Companies for their Subsidiaries". The report dealt with the main approaches to parental responsibility in the legal systems of OECD-member countries. This legislative review provides us with a sense of the direction in which many OECD states are moving in order to increase protection for subsidiaries against disadvantageous and anti-competitive parental instructions. The review shows that while these protective laws are, in the main, directed against third-party impacts rather than intra-enterprise activities, certain jurisdictions are increasingly recognizing that under company law, a subsidiary may have an autonomous interest, and that the majority shareholder — the parent company — may abuse its right to make decisions for its subsidiary. In order to protect this autonomous interest, some governments — that of Holland, for example — require the disclosure of financial information relevant to the subsidiary's activities. The company laws of Belgium, France, Norway and Switzerland presume an autonomous interest of the subsidiary and seek to promote the economic and financial independence of the subsidiary as an ongoing concern. The parent must assume liability where it violates the subsidiary's autonomy.[2]

The European Economic Community's (EEC) draft directive on Groups of Companies (that is, MNEs), which is patterned on Germany's company law, points out the distinction between third-party and intra-enterprise activities. It recognizes that the parent does not have the absolute right to direct its subsidiary's activities unless there is a contract of domination between the parent and its subsidiary; where there is such a contract, the parent assumes obligations relating to the subsidiary, its creditors and its minority shareholders. The German statute has two main provisions:

- Where a control contract or contract of domination has been entered into between the parent and the subsidiary, the parent may issue binding instructions to the subsidiary's management, but at the same time, the parent must undertake to protect the subsidiary's creditors and minority shareholders by making an 'annual equalization payment' to the subsidiary. This payment could take into account the previous earnings and future prospects of the subsidiary and, on that basis, could be calculated to represent average prospective earnings per share so that the minority shareholders and creditors would be no worse off financially as a result of the parent's dominance.
- Where there is no control contract, the parent may nevertheless wish its subsidiary to carry out 'disadvantageous instructions'. German law provides that where the parent issues such instructions, it must compensate the subsidiary for any resulting financial loss. Here the autonomous interest of the subsidiary is recognized only to the extent that the right of the parent to issue any instructions to its subsidiary is limited by financial implications.

Under the labour laws of certain OECD countries, where the parent company is found to be the real employer (that is, where it is 'calling the shots'), the parent, because of its control, can become identified with the subsidiary as the primary employer, and thus be held accountable for obligations arising from the contract of employment.[3] In the United States, the concept of the 'ally employer' tends in this direction. Thus where there is an intra-enterprise abuse, to use the term we have coined, one consequence would be joint and several liability.

It is clear that certain labour laws, the EEC draft directive, and German company law do not go as far as the Freuhauf court decision in protecting the foreign-controlled subsidiary. The French court prevented the subsidiary from carrying out disadvantageous instructions. Similarly, the Combines Investigation Act is directed to

preventing the subsidiary from carrying out such instructions. The German company law, on the other hand, does not aim to prevent directly the carrying out of disadvantageous parental instructions; instead, it seeks compensation for the subsidiary. But compensation makes sense only if third parties are involved, as, for instance, might occur if employees claim severance pay when a plant is closed down by its parent; where there is no such involvement, the parent is compensating itself indirectly by reimbursing its wholly-owned subsidiary. Hence, the EEC draft directive does not go far enough in protecting the interest of an autonomous subsidiary.

Implementing an autonomous subsidiary interest starts with the adoption into the legal system of a general principle, as with the Freuhauf case. The process then requires an adequate information base on intra-enterprise activities and on the source of control for the MNE's strategic planning. Lastly, it may require laws of general application to insulate the foreign-controlled subsidiary from parental interference and, where necessary, even to penetrate to the real decision makers. At the very least, independent directors should be entrusted with this responsibility to protect the autonomous interest.

A much greater flow of reliable information about intra-enterprise activities, to a degree that may be termed 'transparency of information', is a necessary precondition to protecting the autonomous interest of subsidiaries. The recent "Report of the Director of Investigation and Research of the Combines Investigation Act on the State of Competition in the Canadian Petroleum Industry" reflects this objective. The Director recommended that: "legislation be enacted to grant the appropriate authorities the necessary power to obtain information that is stored abroad by the parent or affiliated company of a Canadian company, where that information relates to activities affecting competition in Canada."[4]

In the absence of laws which encourage access to information, the courts may deny such access. This happened recently before the British courts, where the plaintiff sued a British parent company and required access to information in the possession of its foreign subsidiary. The court held that it was for the subsidiary's directors to decide whether it was in the subsidiary's best interests to accede to this request.[5] This decision represents an expression of complete support for the protection of an autonomous subsidiary's interest by making the subsidiary the judge of its own interests. If courts in the foreign parent's jurisdiction were to recognize the interest of an autonomous subsidiary while allowing the Canadian subsidiary or the host state access to information stored abroad by the parent, we

should have the best of both worlds. But it is unrealistic to expect this. U.S. parent companies, for example, would not be able to resist U.S. court decisions seeking information possessed by their Canadian subsidiaries. This state of affairs led the Provinces of Ontario and Quebec, as well as Australia and the United Kingdom to enact 'blocking' legislation; more recently, such legislation has been proposed by Canada's federal government. The Ontario and Quebec legislation has been enacted because, until now, governments in Canada have seen no benefit in gaining access to information in the possession of parents abroad. Instead, it was in their interests to block the parents' access to information held by their subsidiaries.

How, then, are we to balance the need for access to certain information, held by the parent, about intra-enterprise activities, while at the same time allowing the subsidiary to be the judge of its own interests, along the lines of the British court decision? The home or host state may have reasons of legitimate national security or public interest for limiting the two-way flow of information, but short of such reasons, transparency of information should be encouraged. Bilateral arrangements and machinery which recognize this need to balance information flows should be encouraged. While this approach is second-best to the British court decision in terms of recognizing an autonomous subsidiary's interest, reasons of national security and public interest will have to take priority if a worthwhile agreement is to be achieved.

Last, of recent note on the disclosure of information in other jurisdictions is the Vredeling proposal, now before the European Parliament. This proposal would force a parent with subsidiaries in Europe to a make sweeping disclosure of its global operations, twice a year, to local labour unions. It would also oblige parents to consult with and inform the unions of any major decisions that might affect the subsidiary's employees. The proposal suggests penalizing companies for non-compliance. A parent's largest subsidiary in the host state would be responsible for discharging penalties arising from the parent's non-compliance; such penalties might consist of the suspension of the right of the subsidiary to pay dividends to the parent or the government's refusal to permit large-scale lay-offs. Fines would be imposed for each day's delay in meeting these obligations.[6]

Recently, the Ontario Securities Commission (OSC) implemented what was, in effect, such an intra-enterprise-abuse theory. In a particular case that came before it, the OSC insisted that a "sterilization agreement" between a foreign parent and its Canadian subsidiary be established so that inappropriate outside influence by the parent company would or could be avoided.[7] The agreement con-

tains an explicit limitation on the right of the parent to make decisions for the subsidiary. Similarly, an order of the U.S. Federal Trade Commission, directed to AT&T prior to the anti-trust settlement, had required that enterprise to split its operations into two parts so as to allow a 'fully separate subsidiary' to undertake a data-processing service.

Perhaps most of the recent jurisprudence on the question of subsidiary autonomy has dealt with the control of combines or restrictive business practices. Most of these cases have taken place in Europe under Articles 85 and 86 of the Treaty of Rome. Under Article 85, a parent and subsidiary must seek an exemption from a regulatory authority if they wish to engage in intra-enterprise practices that would normally constitute a restrictive business practice. The European Court of Justice has held, in effect, that there is no intra-enterprise conspiracy where the subsidiary "does not have real autonomy in determining its line of conduct on the market and if the agreements or practices have the aim of establishing an internal distribution of tasks between the undertakings."[8] This statement would seem to argue against an autonomous subsidiary interest. But there remains a controversy concerning what constitutes 'mere allocation of tasks'. One commentator has suggested that a directive from the parent to its subsidiary to follow a different pricing or commercial policy in each territory, or one which imposes market restrictions to protect the territory assigned to each subsidiary, goes further than a 'mere allocation of tasks' and thus may violate the Treaty provision.[9] In such event, the autonomous interest would be recognized.

The Canadian Combines Investigation Act exempts intra-enterprise activities from a number of prohibitions, such as conspiracy, exclusive dealing, market allocations, and resale-price maintenance. Some of the OECD states do not exempt the parent-subsidiary relationship from their jurisdiction when they are examining the subsidiary's anti-competitive practices or determining the subsidiary's market power or monopoly position in relation to third parties.

We have seen that the French civil courts have recognized the essence of an autonomous subsidiary interest and an intra-enterprise-abuse theory. More recently, the foundation necessary for protection of an autonomous subsidiary interest, transparency of information, has started to take hold in some OECD-member states and, more generally, within the EEC. Specific instances of the protection of this interest — in some jurisdictions, through defence against disadvantageous instructions or anti-competitive directives,

including the recent OSC sterilization-pact decision — are coming to the fore, but no jurisdiction has yet adopted a general approach to intra-enterprise activities that recognizes, as a principle to be applied to all relevant legislation, the need to protect an autonomous subsidiary interest. This paper will now examine how such protection could be offered, and how Canadian legislation might move in this direction.

The Proposal

Canada has not so far followed a formal legal approach to promoting an autonomous subsidiary interest. Instead, while public policy statements, such as non-binding guidelines, have sought to encourage increased subsidiary autonomy, and while the Foreign Investment Review Agency (FIRA) attempts to negotiate world product mandates, laws of general application have not encouraged the attainment of autonomous subsidiary interest. The uncertainty of negotiating and adhering to terms of entry for foreign-controlled subsidiaries might be replaced by such general laws and procedures. Four steps are proposed which, if implemented, should provide sufficient guidance to businessmen:

- Build on the OECD experience of limiting the parent's right to make decisions for its subsidiary by adopting the general legal principle that laws impacting on intra-enterprise activities should recognize an autonomous subsidiary interest. Develop the concept that a parent can abuse its rights to participate in the decision-making process of the subsidiary by failing to protect the separate interests of the subsidiary.
- As a transitional measure, allow FIRA to retain a role. Redefine, however, 'significant benefits' in the FIRA legislation to mean subsidiary autonomy in decision making for the manufacturing sector. Hence, until such time as laws of general application are in place, there would be a new recognition of what constitutes significant benefits for Canada. This could mean that the foreign investor, instead of focusing on specific performance-related guarantees, would undertake, to FIRA's satisfaction, that its subsidiary would operate autonomously; furthermore, the decisions over which the subsidiary would exercise control would be spelled out.
- Review all laws touching upon intra-enterprise activities — company, bankruptcy, labour, tax, and anti-combines laws — to ascertain what approach would encourage increased subsidiary

autonomy; clarify the responsibilities of directors to monitor and supervise intra-enterprise activities with a view to protecting the autonomous subsidiary interest.

- In order to reinforce the legal approach set out above, develop 'rules of the game' (not laws), spelling out this autonomous interest. These rules should be enunciated as voluntary and non-binding guidelines. It is recognized that certain decisions are for the parent to make alone or jointly with the subsidiary, and that this practice is consistent with an autonomous subsidiary interest. Such decisions as those relating to capital expenditures and appointment of key employees (see Table 2-2) fall into this category. Other decisions, such as those relating to exports, territorial restrictions and restrictions on research and development (R&D), may vary according to sector and other circumstances.

The purpose of this last step is to define the autonomous subsidiary interest in a non-legal setting. Guidelines that are voluntary and non-binding, such as the OECD Guidelines and the Gillespie Guidelines, should be clarified by domestic implementation machinery. This machinery should be set up to seek the assistance of industry and labour in clarifying the guidelines, and to provide direction in establishing what constitutes a reasonable devolution of autonomy in decision making. But clarification of the guidelines and its outcome should not be confused with the process advocated in the third step: that is, the adoption of laws to protect an autonomous subsidiary interest. These are separate, yet mutually reinforcing, processes.

What follows is an elaboration of the key elements of this proposal.

A New Legal Framework

The internal allocation of tasks between the parent and subsidiary has hitherto been regarded, in law, as the exclusive preserve of the parent company and as an expression of the parent's decision-making authority. The parental right has gone largely unchallenged, although minor exceptions have crept in under sections 31.5, 31.6 and 32.1 of the Combines Investigations Act, an amendment to this Act, proposed in 1977,[10] and transfer pricing in the context of taxation law. In general, the subsidiary's activities are likely to be viewed by a court as merely carrying out the instructions or policy of the parent and therefore as legally valid. Questioning the absoluteness of this principle is tantamount to proposing

recognition that a degree of autonomy and legal authority in decision making belongs to the subsidiary. Just as the 'separation of ownership and control' of public corporations led to the emergence, in the 1930s, of securities legislation to protect minority shareholders, legislation may now be needed to limit the unfettered exercise of the decision-making authority held by the parent's management in order to take account of the subsidiary's independent interest. Corporate governance of a subsidiary by its own board — a board on which a large number, but not necessarily a majority, of members would be independent of parental management — would promote this autonomous interest.

Let us consider, as an example, the application of such an intra-enterprise-abuse theory to competition policy. In recognition of an autonomous subsidiary interest, competition policy should concern itself with barriers that deny to the subsidiary the opportunity to innovate or to improve its economic efficiency. Denial of such opportunities may cause the subsidiary to forgo increased domestic procurement; or it may deprive the subsidiary of the freedom to search out the lowest-cost supplies internationally or to seek R&D opportunities.[11]

As an alternative, we suggest the construction of a new legal framework in which the subsidiary is expected to exercise certain decision-making powers, in conformity with the host state's machinery and laws. Our contention is that it is in the parent firm's interests to support an increasingly autonomous subsidiary in an internationally competitive market-place. In many cases, the MNE is already located in Canada and has a distribution network there. Canadian subsidiaries have demonstrated excellence in a number of sectors, and Canada may offer MNEs other advantages to which we have alluded earlier.

The new laws we suggest would enhance the subsidiary's negotiating strength with its parent by promoting the subsidiary's autonomy and protecting it against disadvantageous instructions. In view of its new independence, an 'instinct for survival' and entrepreneurship could be expected to lead the subsidiary's management to acquire as large a degree of control as possible. This measure of autonomy and the exercise of entrepreneurship would probably lead to the subsidiary's acquisition of world product mandates for high-technology products, rather than products near the end of their life cycle. As for single-product firms, the prospect of competition between parent and subsidiary is no longer sufficient reason to limit the Canadian subsidiary's jurisdiction. Internal competition among single-product business units, as witness the IBM system or the Ford

example previously noted, often leads to improved products or even product differentiation.

Preventing Intra-Enterprise Abuses

Laws affecting the MNE's business activities — company, labour, tax, anti-combines and bankruptcy laws — should be reviewed from the perspective of whether or not they strengthen subsidiary autonomy and, if not, how they could be made to do so. By way of illustration, laws relating to restrictive business practices, companies and taxation could be amended along the following lines in order to promote an autonomous subsidiary interest.

The Combines Investigation Act

Section 31.6 of the Combines Investigation Act presently prohibits a parent from issuing directives to its subsidiary if the purpose of those directives is to implement a foreign law or to give effect to a foreign conspiracy. It could be widened to prohibit any foreign directive that would:

(i) adversely affect competition in Canada,
(ii) adversely affect the efficiency of trade or industry in Canada without bringing about or increasing in Canada competition that would restore and improve such efficiency,
(iii) adversely affect the foreign trade of Canada without [securing] compensating advantages, or
(iv) otherwise restrain or injure trade or commerce in Canada without [securing] compensating advantages.[12]

Under such a provision, the foreign-controlled subsidiary would be protected against anti-competitive instructions, subject to a rule of reason. Compensating advantage is intended to balance the fact that the subsidiary is denied the right to expand its product line by giving it some opportunity of equal value. However, this provision is intended to prevent general directives being issued to the subsidiary against, for example, exporting.

In 1977 an amendment to the Combines Investigation Act was proposed.[13] It was intended to prevent instructions from parent companies to their subsidiaries, relating to exports or imports, where the purpose of the restriction was to protect price levels in Canada. This provision was not controversial, but the amendment

did not pass because it was part of a package that was rejected at the time. Again, the notion of a Canadian tribunal interposing itself between the parent and the subsidiary to protect the latter from anti-competitive instructions was not foreign to Canadian legislators.

A broadly-worded prohibition against anti-competitive instructions, coupled with a 'rule of reason' test, would establish an intra-enterprise-abuse principle in this statute. It would then be for a specialized tribunal to apply the law. This possibility is discussed below.

Company Law

Different approaches to encouraging an autonomous subsidiary interest arise under company laws. These laws contain special provisions for MNEs, such as:

- Disclosure of information
- Protection of subsidiary against disadvantageous instructions
- Responsibility of directors.

One way to obtain information about the activities of a parent and its subsidiary would be to require an appropriate annual financial disclosure along the lines of the recently adopted Seventh Directive of the EEC. If this practice were adopted in Canada, it would mean that the assets, liabilities and financial position of the global parent and of its Canadian subsidiary would be disclosed, as would intra-enterprise activities. Additional requirements could extend to the disclosure of planning information, as set out in the Vredeling proposal, although this is not recommend here.

Subsidiaries in Belgium, France, Germany, Norway and Switzerland are entitled to protection against disadvantageous instructions from their parent companies that might affect the capital basis and viability of the subsidiary as an independent concern. Such provisions could equally be adopted in Canada.

For many wholly-owned Canadian subsidiaries, company law allows that the discretion of board members may be fettered; this means that directors are excused from responsibility where the parent signs a unanimous shareholder's agreement. This approach goes against the thrust of these European laws to protect a subsidiary against disadvantageous parental instructions. Although, under German law, a parent is allowed to direct its subsidiary's affairs, there are, in certain cases, onerous financial implications for the parent company in relation to minority shareholders and third

parties. This is not the situation in Canada. The draft Ninth Directive on harmonizing EEC company law follows the approach of German law. An autonomous subsidiary interest would be encouraged by rejecting the notion in Canadian company law of a unanimous shareholders' agreement, which absolves the directors of responsibility. Instead, laws that prohibit such disadvantageous instructions would protect the subsidiary's autonomy. It may be that in certain cases, it would be appropriate to attach responsibility to the parent company, where the autonomous subsidiary's interest is clearly infringed by the parent. The non-binding guidelines (discussed further, below), which would be continually up-dated, with appropriate input, should provide suitable guidance to directors in those cases of disadvantageous instructions and restrictive business practices against which the directors would have a responsibility to protect the subsidiary.

The role of directors in protecting an autonomous subsidiary interest is discussed separately below.

Tax Law

A recent OECD report entitled *Transfer Pricing and Multinational Enterprises* suggested that an analysis of the functions of the various entities within the MNE is always useful in examining transfer pricing.[14] To establish which entity undertakes the risks and the responsibilities is helpful in assessing where a profit is likely to arise and the size of that profit. Hence an enterprise that undertakes much of the risk without showing proportionate profits may be engaged in transferring some of its profits to an affiliated enterprise.

It may be possible to transfer this 'functional analysis' approach into a tax-incentives program that would entitle to a reduced tax rate any business unit that recognizes an autonomous subsidiary interest by bringing together all activities within the subsidiary. Hence, where all activities — from R&D to marketing — are housed within a Canadian firm, whether foreign owned or not, that business unit might be entitled to compensatory tax treatment.

The OECD report also condemned the global or unitary tax method as contrary to the OECD Model Double Taxation Convention. However, numerous U.S. states have adopted a unitary tax system whereby a subsidiary can be taxed on a percentage of its business activities within that state as related to its world-wide activities, irrespective of the profits earned in that state. Foreign and domestic multinationals and home states, such as Canada, have

complained to the United States, on behalf of Alcan Ltd., about the potential for double taxation arising from this unitary tax system. It may be that a unitary tax system could be imposed in Canada in those cases where the functional analysis approach demonstrates that the Canadian subsidiary is not an independent business unit. More data is needed on the costs and benefits of this option, and the feasibility of implementing it, since Canadian authorities would need access to head-office records in order to pursue information extraterritorially. This problem is explored further in the next chapter.

The Role of Directors

Directors of foreign-controlled subsidiaries stand in a fiduciary relationship, or a position of trust, towards the corporation. This proposition stands as a general rule of corporate law. There is a commonly held view that in the case of a wholly-owned subsidiary, it is less likely, as compared with the case of a partially-owned subsidiary, that there could be any conflict between the obligation of the directors to the subsidiary, as against their obligation to the shareholder, that is, the parent company. If there is a conflict, the duty is owed to the subsidiary.[15]

This notion that conflict is unlikely between a wholly-owned subsidiary and its parent, but possible where the subsidiary is partially-owned, assumes that the interests of wholly- and partially-owned subsidiaries are not identical. This premise is not accepted here. Once a subsidiary is recognized as having an autonomous interest, the potential for conflict of interest is the same whether it is wholly owned or partially owned.

Where the parent and subsidiary have the potential to compete with each other, should the subsidiary's director accept jurisdictional or territorial restrictions imposed on the subsidiary at the direction of the parent if these restrictions mean loss of business for the subsidiary? At a recent conference on the role of directors of subsidiary companies, MacIntosh advised that "the independent director must be confident that such limitations are really in the interest of the subsidiary, because his obligation is to act with a view to the best interest of the corporation."[16]

Using the board of directors to promote an autonomous subsidiary interest may be the preferred way of achieving this end. If, however, the means does not prove to be effective, then it would be necessary to adopt laws of general application proposed above. A

recent article on corporate governance, published in the *Harvard Business Review*, argues that the board should be the primary force pressing the corporation to full achievement of its objectives. Corporate governance is defined as:

> . . . the processes, structures, and relationships through which the board of directors oversees what its executives do. By *corporate management*, I mean what the executives do to define and achieve the objectives of the company. If good management is the face of the coin, good governance is its other side.[17]

Improving corporate performance is tied to improving the effectiveness of corporate boards of directors. The importance attached by the author of the article to corporate governance and its potential application merits a closer look at his five concepts of corporate governance:

> The board has a vital role in protecting the corporation's future, that is, taking the long-range view.
> The board must be independent of management.
> The ideal board cannot be what we want it to be — that is, independent and future oriented — if it includes management members other than the [chief executive officer]. An executive committee made up of the CEO and all non-management board members is proposed.[18]
> The chairman of the board should not be the CEO, since the latter's duty is to present and promote his or her plans and programs, whereas the chairman's duty is to challenge and question proposals.
> A board needs an informed and independent view of the corporation, and this view comes from the chairman of the executive committee.[19]

What is the Canadian experience of foreign-controlled subsidiaries in which significant board-level decisions about operations are made by the managements of the subsidiary and the parent, bypassing the board's processes? It has been reported that in only 10 per cent of one sample have boards given formal approval to strategic plans for Canadian operations before they were submitted to the parent companies. The researcher concludes that in only five out of forty-seven U.S. subsidiaries in Canada is there a strategic-planning process that enables those companies to follow the Gillespie Guideline, that is, to pursue a high degree of autonomy in the

exercise of decision-making.[20] One may conclude from this that highly qualified outside directors would be reluctant to serve on the boards of foreign-controlled subsidiaries. What can be done?

First, the duty of directors to monitor and supervise the company's affairs in its best interests should be defined as including protection of an autonomous subsidiary interest. The recent report of the Royal Commission on Corporate Concentration drew attention to the general need for more active and responsible directors to serve as a check on management, as well as for outside directors for the larger foreign-controlled subsidiaries. These outside directors, particularly if armed with funds to command independent expertise, would insulate the subsidiary from its parent and could prod management to exercise greater independence in its decisions.

Secondly, an audit committee with a majority of outside directors could oversee any matter involving parent-subsidiary intercourse. The Commission was of the opinion that the audit committee should include a majority of outside directors.[21] Subsidiary autonomy would be increased by such a committee.

Thirdly, disclosure in annual reports filed with a monitoring agency of the audit committee's investigations and of other statements by directors might also increase autonomy.

The powers of the host state to legislate the protection of an autonomous subsidiary interest, together with a provision enabling a large number of outside directors[22] to protect this interest, when taken together, provide the essence of a legal approach to regulating intra-enterprise activities across national boundaries.

Identifying Intra-Enterprise Abuses

Non-binding, general guidelines that set forth what activities would constitute an intra-enterprise abuse would serve to identify what comprises an autonomous subsidiary interest. These guidelines would recognize the need to balance subsidiary autonomy against the parent company's right to protect its investment and to take part in decisions involving substantial commitments which may affect the parent. The parent has a legitimate responsibility to its own shareholders and, as we have noted in Chapter 2, an allocation of activities may give rise to increased costs for the enterprise; hence, there is a need to strike a balance between increased subsidiary autonomy and the parent's concern for its investment. The parent could retain a right to appoint management and to veto important financial commitments. To determine where the line is to be drawn

on the sharing of decision-making powers requires, in the first instance, a non-adversarial clarification *process*.

One model for implementing such a process is the OECD consultative procedures machinery that gives effect to the OECD Guidelines. A committee of the OECD clarifies these Guidelines for MNEs by inviting representatives from industry, labour and government to discuss particular provisions. This process of clarifying the Guidelines has the potential to be used successfully and has been shown, in the few cases where complaints have been made to the Committee, to be an effective instrument in influencing MNE behaviour. Thus a point of departure may be adoption of a guideline along the lines of paragraph 5 of the General Policies of the OECD Guidelines, which states that MNEs should "allow their component entities freedom to develop their activities and to exploit their competitive advantage in domestic and foreign markets, consistent with the need for specialization and sound commercial practice".[23] A first step, then, would be to 'flesh out' this provision and related guidelines by *establishing domestic implementation machinery* along the lines of the OECD Committee. This machinery should limit itself to fact-finding, not decision making, and to general clarification, rather than to specific cases. Its role should be advisory in that its statements would serve to define what constitutes a 'reasonable autonomous interest' for subsidiaries in different sectors. At the enforcement stage, this definition could provide useful direction to a tribunal charged with determining whether an autonomous interest has been abused by a parent company.

The best-known case to come before the OECD Committee was the Badger case, in which a Belgian subsidiary went bankrupt, and it was alleged that the parent or other Badger subsidiaries had forced the Belgian subsidiary out of business. Only 40 per cent of termination payments to employees were paid out, and the parent denied any liability for the balance. The Committee, without deciding on the merits of this particular case, clarified the guidelines by deciding that where the parent effectively makes a decision to shut down a subsidiary, the parent, as the real decision maker, should be financially responsible for the consequences.[24]

Mergers and Take-overs Involving MNEs

We have been discussing the intra-enterprise activities of the MNE and the allocation of decision-making power as between parent and subsidiary. Where there is a foreign take-over of an existing Canadian business, there may be, in a few cases, anti-combines con-

siderations. As a point of departure, as long as the autonomous interest of the newly-acquired manufacturing firm is protected, that firm should be allowed to continue in business as a foreign subsidiary.

But separate competition issues may arise. It has been suggested that 'paper entrepreneurialism' is wasteful and inefficient.[25] In the resource sector, some U.S. oil companies are trying to solve those particular firms' problem of falling oil reserves by taking over their competitors. While this action may solve the immediate reserve problem of those particular firms, it does not solve the problem of falling oil reserves for the country as a whole. Similarly, in the manufacturing sector, many mergers or take-overs create no new productive capacity. At the very least, the merger or take-over should be decided on the basis of criteria that relate to economic efficiency, subject to recognition of an autonomous subsidiary interest. These criteria could be incorporated in an approach similar to one proposed, but not adopted, in 1977, in amendments to the Combines Investigation Act, whereby a Competition Board, using economic-efficiency criteria, would have reviewed mergers and take-overs when "the merger or proposed merger has brought about or [when] there is a high probability that it will bring about substantial gains in efficiency. . . ."[26] In a take-over by a foreign firm, criteria of economic efficiency should be considered by the Board to include international competitiveness and an opportunity to make innovations. If such elements were included in the criteria for economic efficiency, these criteria would also be consistent with the preamble to the Combines Investigation Act proposed in 1977, which said that "a central purpose of Canadian public policy is to promote the national interest . . . by providing an economic environment that . . . stimulates innovation in technology and . . . expands opportunities relating to . . . export markets."[27] Therefore, the proposal could apply to the Canadian business enterprise taken over, although it would first have to satisfy the tribunal separately, on grounds of international competitiveness, concerning its rationale for the merger or take-over.

Enforcement

Specific laws could be amended to support autonomous subsidiaries. A specialized tribunal, such as a competition board, might hear all cases involving an alleged infringement of a particular subsidiary's autonomous interest. The clarification of the Guidelines by the domestic machinery, previously mentioned, might help

to determine what decisions would protect the autonomous interest of subsidiaries under specific laws. Such guidelines might be expected to show in what cases a directive imposing restrictions would be valid: for example, where or to whom or in what form or quantities goods may be resold or exported. The Combines Investigation Act would be expected to provide sanctions against directives that adversely affect Canada's foreign trade without offering some compensating advantage. If the guideline were clarified early in the process, the business community and the tribunal would receive some guidance concerning how such rules might be applied. This would add some certainty to the 'rules of the game'. Among a variety of possible enforcement sanctions that the tribunal could impose if it found against a firm might be an injunction forbidding the parent to issue harmful directives; the imposition of a tax, on a unitary basis, on the MNE's activities; or the disallowing of any existing incentives.

Notes

1. *Frenhauf Corporation* v. *Massardy et al.*
2. Organisation for Economic Co-operation and Development (OECD), *International Investment and Multinational Enterprises: Responsibility of Parent Companies for their Subsidiaries*, paragraphs 19–21.
3. *Ibid.*
4. Canada. Director of Investigation and Research, Combines Investigation Act, *The State of Competition in the Canadian Petroleum Industry, Volume 1, Findings, Issues and Remedies*, p. 127.
5. In the Lonrho case, the Court of the United Kingdom held that it was for the subsidiary's board of directors to decide whether to accede to the parent company's request to produce documents: "These [interests] are not exclusively those of the [subsidiary's] shareholders but may indeed be those of its creditors." *Lonrho Ltd. et al* v. *Shell Petroleum Co. Ltd. et al.*, p. 367.
6. R.I. Kirkland, "Bad News Brewing in Brussels", p. 142; R.G. Caborn, "Workers Have a Right to Know More". Periodic revelations by the parent concerning the MNE's financial position, development and employment plans, marketing strategies, new products and technologies, as well as other developments that affect workers would be included. In addition, a company would have to give thirty days notice before closing a plant.
7. "'Sterilization' pact discussed at Bache Canada appeal", *Globe and Mail* (Toronto, 16 September 1981), p. B12. The OSC caused the parent

and the subsidiary to enter into an agreement strengthening the autonomy of the subsidiary.

8. *Centrafarm B.V.* v. *Sterling Drug Inc.* p. 482. The Advocate General argued that Article 85(1) of the Treaty was infringed where intra-enterprise agreements and practices have the effect of restraining competition affecting third parties, particularly where an MNE's trade barriers restrain third parties' efforts to gain access to a particular market.

9. P. Gide, *Le droit de la concurrence des communautés européennes*, pp. 27–28.

10. See ss. 31.5, 31.6 and proposed (1977) ss. 31.61 and 32.11 of the Combines Investigation Act. In the 1977 proposals to amend the Combines Investigation Act, s. 31.61 would have provided for a Competition Board to interpose itself between the parent and the subsidiary by prohibiting certain agreements or arrangements whereby the price at which the subsidiary sold its product was directed by the parent, with a view to discouraging imports into Canada or exports from Canada.

11. D.H.W. Henry, "Anti-Monopoly Legislation in Canada", p. 291.

12. Combines Investigation Act, s. 31.5.

13. Combines Investigation Act, proposed s. 31.61.

14. OECD, Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises*, 1979, para. 17.

15. *Canadian Corporate Directors on the Firing Line: A conference report.*

16. *Ibid.*, p. 80.

17. K.N. Dayton, "Corporate governance: the other side of the coin", p. 34. Emphasis in the original.

18. The Hudson Corporation Board, described by Dayton, is composed of fifteen members. Twelve of these are 'outside' directors, who meet specific criteria and who represent a mix of qualifications.

19. Dayton, "Corporate Governance".

20. Clarkson, "Working Together".

21. Royal Commission on Corporate Concentration, *Report*, p. 307.

22. Legislation would be needed to prevent the parent from reducing the quota of outside directors to an insignificant number. On the roles, responsibilities and choosing of outside directors, see generally "Boards of Directors: Part I", *Harvard Business Review*, and in particular, C.D. Stone, "Public directors merit a try", *Harvard Business Review* 54 (March-April 1976): 20–34, 156; R.F. Lewis, "Choosing and using outside directors", *Harvard Business Review* 52 (July-August 1974): 70–78; and Dayton, "Corporate Governance".

23. Organisation for Economic Co-operation and Development (OECD), "Guidelines for Multinational Enterprises".

24. T. Vogelaar, "The OECD Guidelines: Their Philosophy, History, Negotiation, Form, Legal Nature, Follow-Up Procedures and Review", and R. Blanpain, "The OECD Guidelines and Labour Relations: Badger and Beyond".
25. R.B. Reich, *The Next American Frontier*.
26. Canada. Consumer and Corporate Affairs. See proposed s. 31.71 (5).
27. Canada. Combines Investigation Act (1977 proposal), preamble.

6: *Public Policy Implications for Canada*

Introduction

The multinational enterprise (MNE) is expected to undergo, or is already undergoing, a fundamental change in corporate strategy at the same time that the organization of production in international business is changing. Public policy responses drawn up in the early 1970s may, therefore, no longer be appropriate. In addition to supporting existing domestically controlled industry, encouragement of the growth of subsidiaries should be supported, and means of achieving such support, other than exacting performance undertakings on entry of an MNE into the country, should be investigated. This paper suggests some possible avenues of investigation. Specifically, we have proposed that an internationally competitive model is necessary, a model that encourages innovation and entrepreneurship. This development, in turn, requires autonomy in decision making. To bring this state about, it is necessary to recognize in law the subsidiary's autonomous interest, along with the corollary that the parent company's right to make decisions for its subsidiary would have to be limited in certain cases. The identification of these cases would require, first, that voluntary guidelines set out the 'rules of the game'; secondly, company, tax and other relevant laws may be required to support, where appropriate, the principle of an autonomous subsidiary interest; however, company law should clarify the role of the subsidiary's directors in supporting this principle.

The result of public policy that encouraged greater autonomy for subsidiaries operating in Canada, along the lines discussed here, would be increased growth and development arising from export-led growth, coupled with the utilization of a highly skilled workforce. This paper does not, however, address the productivity problems of Canadian-owned manufacturing firms as they seek to adjust to the more competitive international environment of the 1980s and beyond. It enquires, rather, into Canada's preparedness for the change-over in MNE corporate strategy from the market-seeker to the production-efficiency-seeker model and asks whether, why and how government policy should seek to influence that change-over.

The objectives of improved subsidiary productivity and its implementation should be pursued simultaneously at international and domestic levels. On the international front, Codes of Conduct for MNEs, currently being debated at the United Nations, could benefit from an infusion of different perspectives, other than those supplied by the North-South dialogue, which has further politicized the issue of control over the MNEs' activities. To promote the opportunity for subsidiaries to develop an innovative capacity, along with the means to use it, supports the host countries' goal of providing equality of opportunity, while not involving governments in obtaining performance undertakings from MNEs. The Code of Conduct for MNEs, developed by the Organisation for Economic Co-operation and Development (OECD), exemplifies a voluntary, non-binding code of conduct with implementation machinery. Until now, it has been primarily the labour unions that have made use of this machinery. It may now be appropriate for host states, such as Canada, to seek clarification of the OECD guidelines, with a view to encouraging their refinement, where appropriate, to promote the increased autonomy of subsidiaries.

The OECD's implementation machinery provides an example of a tripartite process that could be emulated by host states in order to foster greater understanding and clarification of the 'rules of the game'. Adoption of a policy which encourages greater autonomy of decision making by subsidiaries should be coupled with a clarification process, developed to identify key decision-making authority, which will support subsidiary autonomy, and which will be patterned on the process used by the OECD Committee.

The OECD's 1980 *Report on Responsibility of Parent Companies for their Subsidiaries* shows Canadians how some other members of the OECD are developing laws to protect the subsidiary and third parties. (Canada has lagged behind in this development, although this lag may be explained by the existence of the arguably alternative

process of the Foreign Investment Review Agency [FIRA].) There has been no systematic approach in Canada to supporting, at the very least, increased parental responsibility for the decisions a parent takes on behalf of its subsidiary; nor have there been limitations on the parent's ability to make decisions affecting a subsidiary without regard for the autonomous interest of that subsidiary.

On the domestic front, it has been suggested that there is a need to review Canadian laws relating to the parent-subsidiary relationship, with a view to encouraging increased subsidiary autonomy by introducing into appropriate laws an intra-enterprise-abuse component. Such an approach would mark a departure from that of FIRA, which is to focus on the need to regulate the foreign parent's 'control in fact' by exacting performance requirements agreed upon by the parent company as a condition of entry into Canada. The approach advocated here accepts the thesis that foreign ownership may be compatible with Canadian 'control' or influence, or with the existence of an autonomous subsidiary in which Canadian-based management has decision-making authority, and that this latter approach is to be preferred, since it is capable of instilling an entrepreneurial spirit in a subsidiary, which is essential for its dynamic growth.

For the MNE and its home government, it is submitted that the approach just proposed should be preferred, since it involves less host-state intervention — once the limits of the subsidiary decision making are clarified and the 'rules of the game' are understood — and no performance guarantees are required. However, the tension created by a policy that seeks to lessen parental control over decision making while, at the same time, it tries to increase the flow of technology to that parent's subsidiary or to encourage in-house research and development (R&D) by the subsidiary, may lead some MNEs to reduce R&D support for that subsidiary. In addition, improved communication systems can be used to enhance parental control. Yet world product mandates are on the increase; there is a trend towards increased specialization of manufactured goods in international markets; and, over time, it is expected that the manufacturing process will become more flexible and more thoroughly integrated into the marketing system. In that environment, the MNE can be expected to organize production so that its subsidiary should operate autonomously. This proposal seeks to encourage this development and even to accelerate it. That there will be some tensions and some resistance can be expected. But with time and clarification of the rules, the proposal should come to be accepted, and it should bring with its acceptance the increased productivity and, hence, the increased profitability, of that subsidiary.

Other specific implications for domestic policy would be a review of Canada's competition policy, a reconsideration of our approach to the extra-territorial application of our laws, and the achievement of federal-provincial consensus. Competition policy should encourage specialization in order for Canadian firms to be able to compete internationally. Intra-enterprise-specialization agreements can be arranged without state intervention, but government-supported discussions within an industry may be necessary to encourage the right mix of specialization of activities among the participants. There is a positive role for governments to play, and there is also a need to negotiate with MNE home countries so that they may recognize the need for industry reorganization in Canada. Canada might have to be granted an exemption, for example, from the extra-territorial application of U.S. laws to allow two U.S. subsidiaries in Canada to discuss industry rationalization where international markets are at stake: that is, to negotiate which products each of the two subsidiaries would specialize in producing in Canada to the exclusion of the other's production of those goods. Canada's approach to extraterritoriality would also have to be reconsidered if the intra-enterprise-abuse theory is to become fully effective. This is necessary because, in order to give full effect to this theory, Canada may need to be able to reach the real decision makers — the foreign parents — although it may be argued that if exemption from the extraterritorial application of U.S. anti-trust law is obtained, then, for reasons of reciprocity, Canada should not claim extraterritorial jurisdiction over foreign parents. Lastly, federal-provincial consensus would be required to implement this proposal, since the laws touching upon MNEs' activities fall within both federal and provincial jurisdictions, although it may be argued that the federal role should continue to be paramount, given the fact that the essential point of the proposal is to attract foreign investment.

In sum, I am proposing that an MNE which gives a satisfactory undertaking to confer autonomy in decision making on its manufacturing subsidiary should, as a transitional measure, be exempt from FIRA's performance undertakings. Should it appear subsequently that the devolution of autonomy was not bona fide, the MNE would then have to negotiate more stringent undertakings with FIRA or face other sanctions. In that situation, the scope of FIRA's jurisdiction would be more limited, since a devolution of autonomy, once accepted by FIRA, would automatically remove the need to give performance undertakings; but FIRA's enforcement powers would have to be extended to sanction effectively the MNE that did not live up to its devolution commitment. Norms developed

by an OECD-type committee could provide objective criteria against which to measure the effectiveness of this devolution. In the longer term, a legal approach can replace the FIRA screening agency. This approach would include recognition of the principle that subsidiaries have an autonomous interest, a process to clarify the rules of what constitutes reasonable subsidiary autonomy, clearly establishing the role of directors and protecting the appointment of outside directors and, if need be, adopting specific laws on company, tax, anti-combines, bankruptcy and labour. Instead of FIRA, there would be in place different laws of general application, all of which would have in common an underlying principle supporting an autonomous subsidiary interest.

At a time when increased foreign investment to retool industry may be desirable, and when structural change in the international organization of production is occurring, continuing to screen foreign investment may either fall short of maximizing the productivity of Canadian subsidiaries or may unnecessarily put at risk continued foreign investment in the manufacturing sector. While some may see such investment as a threat to Canada, it should be recalled that the approach proposed here seeks to address the problem diagnosed by the Gray Report, that is, foreign control over decision making. The focus here is on the need to deal with the absence of Canadian-based management or board-of-director control over business decisions affecting foreign-controlled businesses. In effect, the proposal seeks to establish a new balance between the promotion of private sector goals and those of the Canadian nation as a whole. An open society in which Canadians and foreigners alike contribute to improving our productivity and international competitiveness is our best assurance of serving our national interests.

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FIRA

AUTONOMY FOR CANADIAN SUBSIDIARIES?

A president of a foreign-controlled subsidiary recently commented:

> [As]*the Canadian subsidiary of a multi-national, we do not necessarily always operate to do the best we can for our local books. We are attempting to optimize the* [parent company's] *books.*

How can this perspective be changed so that the Canadian subsidiary can gain a heightened sense of its independence as a profit centre, without a change occurring in ownership or formal control relationships? Canadian public policy, contends Samuel Wex, should seek to encourage maximization of the subsidiary's profits by focusing on its productivity and its international competitiveness. Its performance should stamp it as a good corporate citizen.

In order to bring about this change of perspective, different approaches will be needed to create autonomous subsidiaries that are entrepreneurial and outward looking. These approaches, if adopted, could lead to an open-door policy to new foreign investment that would be entrepreneurial and innovative. This development would remove the need for a screening authority, such as the Foreign Investment Review Agency.

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